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LENDER LIABILITY IN MISSISSIPPI: A SURVEY, COMPARISON AND COMMENT

Robert C. Williamson, Jr. and Brenda Kay Tanner***

"FROM THE Oil Patch to the Farm Belt,"[1] lenders are contending with lawsuits brought by financially beleaguered borrowers and their unsecured creditors.[2] The borrower cases ordinarily involve two actors — the lender and a distressed business. The borrower blames the lender for its business set-backs, contending that the lender prematurely called its loan,[3] interfered in business decision-making[4] or withheld material information.[5]

The creditor cases involve three actors — the lender, an insolvent business, and an unsecured or undersecured creditor of the business. The creditor blames the lender for the losses it in-

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[1] Victor, *Lender Liability Doctrine Gives Creditors Clout*, National Law Journal, Sept. 1, 1986, at 1, col. 2.

[2] *See, e.g.*, Gray v. First Nat'l Bank of Louisville, No. J88-0324(B)(S.D. Miss. filed June 28, 1988)(seeking 11 million dollars in actual and punitive damages on multiple theories of lender liability); University of Tenn. v. United States Fidelity & Guar. Co., No. 2-130-87 (Circuit Court of Knox County, Tenn. filed March 6, 1987)(bond obligee seeking over 107 million dollars in actual, punitive damages against financing contract surety for alleged domination, control of bond principal on construction projects); Hunt v. Bankers Trust Co., No. 3-86-1984 (N.D. Tex. filed June 24, 1986)(seeking $3.6 billion on multiple theories of lender liability). The authors represent the defendant in the *University of Tenn.* action and are acting as special Mississippi counsel to the lenders in the *Hunt* action. Nothing stated in this Article is intended as a comment on any pending litigation in which the authors represent any of the parties.

[3] *See infra* notes 39-48 and accompanying text.

[4] *See infra* notes 239-268 and accompanying text.

[5] *See infra* notes 116-151 and accompanying text.

curred in extending credit to the business, arguing that the lender used its financial leverage over the business to injure the creditor[6] or that the lender provided the creditor with inaccurate information about the business' creditworthiness.[7]

Lender liability cases are not new. Reported decisions date back to the nineteenth century.[8] The recent explosion in litigation is partially attributable to changes in the economy, the financial industry, and judicial views regarding compensation for injury.[9] A more immediate inspiration for litigation has been the breathtaking verdicts[10] won by disgruntled borrowers and creditors.

Successful claimants have relied on a "dazzling array of

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[6] *See infra* notes 297-348 and accompanying text.

[7] *See infra* notes 408-429 and accompanying text.

[8] *See, e.g.*, American Nat'l Bank v. National Wall-Paper Co., 77 F. 85, 90-94 (8th Cir. 1896)(liability imposed upon lender for scheming to injure borrower's creditors). *See generally*, Rudolph, *The Domination Issue in Contract Suretyship Cases*, 1949 INS. L.J. 740 (1949)(surveying ten early cases).

[9] For an in-depth and scholarly analysis of these changes, see Ebke & Griffin, *Lender Liability to Debtors: Toward A Conceptual Framework*, 40 Sw. L.J. 775, 800-806 (1986).

[10] *See, e.g.*, Landes Constr. Co. v. Royal Bank, 833 F.2d 1365, 1367-68 (9th Cir. 1987)($18.5 million for breach of oral loan commitment); Whitney v. CitiBank, N.A., 782 F.2d 1106, 1113-1120 (2d Cir. 1986)(affirming verdict for $236,677 in compensatory damages, $1.5 million in punitive damages for interference with partnership); 999 v. C.I.T. Corp., 776 F.2d 866, 867-68 (9th Cir. 1985)($925,000 verdict for breach of loan commitment); K.M.C. Co., v. Irving Trust Co., 757 F.2d 752, 754 (6th Cir. 1985)(jury verdict for $7.5 million for breach of UCC implied covenant of good faith in failing to give notice before refusing loan advances); Penthouse Int'l v. Dominion Fed. Sav. & Loan Ass'n, 665 F. Supp. 301, 312 (S.D. N.Y. 1987)($129,904,455 in compensatory damages for breach of loan commitment); Ricci v. Key Bancshares of Maine, Inc., 662 F. Supp. 1132, 1139-43 (D. Me. 1987)($15 million in actual damages for breach of implied covenant of good faith in abruptly terminating line-of-credit); State Nat'l Bank v. Farah Mfg. Co., 678 S.W.2d 661, 667 (Tex. Ct. App. 1984)($18,647,243.77 in compensatory damages).

Some of the most spectacular verdicts have not yielded published opinions. *See, e.g.*, Conlan v. Wells Fargo Bank, N.A., No. 82852 (Cal. App. Dept. Super. Ct., June 10, 1987)(jury award of $10 million in compensatory damages, $50 million in punitive damages for fraud, duress, breach of covenant of good faith, fair dealing, breach of contract), *noted in* 1 Lender Liability L. Rep. 3 (Sept. 1987); Scharenberg v. Continental Ill. Nat'l Bank, No. 84-2712-Civ-Davis; No. 87-0211-Civ-Davis; No. 87-0238-Civ-Davis (S.D. Fla. 1987)($105 million in compensatory damages for breach of loan agreement), *noted in* 1 Lender Liability L. Rep. 4 (Aug. 1987); Solomon & Sands v. First Am. Nat'l Bank, No. 84-1445-I (Tenn. Ch. App. Davidson County, Sept. 23, 1987)($200,000 in compensatory, $1.2 million in punitive damages for fraud, breach of obligation of good faith, reckless disposition of collateral), *noted in* 1 Lender Liability L. Rep. 1 (Nov. 1987).

lender liability theories."[11] These theories include traditional

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[11] Murphy, *Introduction to the Defense and Prevention of Lender Liability*, I ALI-ABA COURSE OF STUDY, LENDER LIABILITY DEFENSE AND PREVENTION 3-4 (1987) [As several articles from this particular publication, volumes I and II, will be referred to herein, the publication will be hereinafter cited as ALI-ABA]. In addition to the common law theories of recovery, certain statutory provisions have been used to support actions against lenders. The Uniform Commercial Code (U.C.C.) provisions of good faith and fair dealing are most often cited. *See infra* notes 27-78 and accompanying text. The U.C.C. provisions of Article Nine are especially pertinent to Mississippi lenders, since a significant portion of financing in Mississippi is agricultural. With the increasing number of defaults and bankruptcies by farmers, lenders' ability to foreclose upon agricultural collateral, including crops, livestock, and equipment, becomes more crucial. For a thorough discussion of Article Nine and its effect on Mississippi lenders, see Meyer, *Agricultural Collateral and Article Nine - Mississippi Style*, 42 MISS. L. INST. 29 (1987). *See also* Burke, *General Observations Concerning Article 9 Sales*, I ALI-ABA 71, at 71-119 (1987)(general discussion of Article 9) [hereinafter cited as Burke, *General Observations*]. For a general discussion of lender liability for agricultural loans, see Bahls, *Termination of Credit for the Farm or Ranch: Theories of Lender Liability*, 48 MONT. L. REV. 213 (1987).

The securities laws may also be used as a basis for asserting liability against a lender. Such liability may arise under the Securities Act of 1933, 15 U.S.C. § 77a *et seq.*, and/or the Mississippi Securities Act, MISS. CODE ANN. § 75-71-101 *et seq.* (Supp. 1987). Under these securities laws, several theories of liability may be asserted against a lender, including liability as a control person, aider and abettor, co-conspirator, principal, information supplier, and/or seller. *See generally* Burke, *Emerging Theories of Lender Liability*, I ALI-ABA 397, 442-462 (1987)(discussion of lender's liability under securities laws) [hereinafter cited as Burke, *Emerging Theories*]; Douglas-Hamilton, *When Are Creditors in Control of Debtor Companies?*, 26-7 PRACT. LAW. 61 (1980)(discussion of control); Enstam & Kamen, *Control And The Institutional Investor*, 23 BUS. LAW. 289 (1968)(same); Heiman, *Impact of Common Law Theories On Lender Recovery and Liability*, IV ABA EMERGING THEORIES OF LENDER LIABILITY 7, 16-17 (H. Chaitman ed. 1987)(same) [As several articles from this particular publication will be referred to herein, the publication will be hereinafter cited as IV ABA Emerging Theories]; Lundgren, *Liability Of A Creditor In A Control Relationship With Its Debtor*, 67 MARQ. L. REV. 523, 546-549 (1984)(discussion of securities laws).

Under the Bankruptcy Code, a lender with sufficient control might be classed as an "insider", with the result that certain transactions may be classed as preferential transfers. For a discussion of the effect of the bankruptcy laws on lenders, see Burke, *Emerging Theories*, *supra*, at 463-64; Lundgren, *supra*, at 523, 552-555; Miller, Bienenstock, Ball & Gatto, *Confirmation of Chapter 11 Plans under the Bankruptcy Code*, II ALI-ABA 863, 863-1040; Murphy, Sheneman & Nelson, *Lender Liability: Remedies and Defenses in Bankruptcy Cases*, II ALI-ABA 759, 759-862. Like preferential transfers under the Bankruptcy Code, the Uniform Fraudulent Conveyance Act (UFCA) can be used to void transfers. *See* Heiman, *supra*, at 31-41. Mississippi has not adopted the UFCA. However, Mississippi has several statutory provisions addressing fraudulent transfers which could be used, like the UFCA, to void transfers. *See* MISS. CODE ANN. §§ 11-5-75, 15-3-5 (1972), 15-3-3 (Supp. 1987)(statutory provisions which provide for avoidance of fraudulent transfers). For a discussion of fraudulent conveyance risks for lenders in

breach of contract and tort theories, such as breach of an ex-

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leveraged buyouts, see Kirby, McGuiness and Kandel, *Fraudulent Conveyance Concerns in Leveraged Buyout Lending*, 43 BUS. LAW. 27 (1987); Murdoch, Sartin & Zadek, *Leveraged Buyouts and Fraudulent Transfers: Life After Gleneagles*, 43 BUS. LAW. 1 (1987).

The Racketeer Influenced and Corrupt Organizations Act (RICO) also can be a source of liability for lenders. *See* Burke, *Emerging Theories, supra*, at 521-594 (discussion of RICO); Greenberg, *An Update On Civil RICO After Sedima And The Implications For Lenders*, IV ABA EMERGING THEORIES 83, 83-100 (same).

Under the Internal Revenue Code, a lender may be liable for unpaid withholding taxes of the borrower. The degree of liability varies according to the extent of participation by the lender. For example, a lender who directly pays the borrower's employees must withhold the appropriate taxes and pay such taxes to the government. Any lender classed as a "responsible person" may likewise be liable for the full amount of taxes. On the other hand, a lender who advances money for payment of wages is liable only up to 25 percent of the amount of advanced funds, even though the lender knows the borrower does not intend to pay the taxes. *See* Burke, *Emerging Theories, supra*, at 462-63 (discussion of liability for withholding taxes); Doernberg, *The Case Against Withholding*, 61 TEX. L. REV. 595 (1982)(same); Douglas-Hamilton, *supra*, at 70-72 (same); Feldman, *Taxation-Exercise Of Only "Significant" Control Over Debtor's Operations Subjects Lender to 100 Percent Withholding Tax Penalty*, 43 FORDHAM L. REV. 898 (1975)(same); Lundgren, *supra*, at 540-546 (same); Thannhauser, Riemer, & Friedman, *Lender's Liability for Unpaid Withholding Taxes of Borrower-Employer—IRC Sections 3505 and 6672*, 80 COM. L.J. 137 (1975)(same); Winston, *Lender's Liability For Borrower's Unpaid Employment Taxes*, TEX. B. J. 1253 (Nov. 1983)(same). Liability for taxes under these provisions extends to any "lender, surety, or other person." Thus, a prime contractor who loaned money to its subcontractor to pay its net payroll was held liable for withholding taxes in United States v. Algernon Blair, Inc., 441 F.2d 1379, 1381 (5th Cir. 1971).

An area of increasing concern to lenders involves the environmental protection laws. Laws to penalize improper disposal of hazardous waste may cause government claims for clean-up costs to have priority over other liens; arguably costs of clean up may become a direct liability of secured lenders. Cohen, *Hazardous Waste: A Threat to the Lender's Environment*, 19 U.C.C. L.J. 99, 99 (1986)(thorough analysis of lender's liability for hazardous wastes under federal and state laws); *see also* Article, *When a Security Becomes a Liability: Claims Against Lenders in Hazardous Waste Cleanup*, 38 HASTINGS L.J. 1261 (1987)(same).

The aforementioned statutory provisions are only a few of many statutes under which lenders may find themselves liable for acts or failure to act of borrowers. *Any* time a lender exercises control over a borrower the potential arises for liability. For a discussion of potential liability under other statutory provisions such as the Investment Company Act of 1940, the Trust Indenture Act of 1939, the Public Utility Holding Company Act of 1935, the Interstate Commerce Act, the Civil Aeronautics Act, the Federal Communications Act of 1934, Antitrust laws, etc., see Enstam & Kamen, *supra*, at 292-297. One author warns that lender liability cases based on statutory provisions should be read with caution since "control liability statutes may have been enacted precisely because common law theories of liability were perceived as inadequate to remedy the targeted ills." Schechter, *The Principal Principle: Controlling Creditors Should Be Held Liable For Their Debtors' Obligations*, 19 U.C. DAVIS L. REV. 875, 906 n.66 (1986).

press promise,[12] fraud[13] and duress.[14] Of particular importance are cases imposing liability upon lenders for breach of fiduciary obligations,[15] breach of an implied duty of good faith,[16] and interference with borrower management.[17]

Theories such as fraud or breach of an express covenant are as viable in Mississippi as in other states.[18] Mississippi courts have not imposed a general fiduciary obligation upon commercial lenders;[19] nor have they used the implied covenant of good faith to prohibit lenders from exercising rights granted them by their loan agreements.[20] Mississippi courts have, however, recognized that lenders may have special disclosure obligations, which extend not only to the lender's own customers,[21] but also to third parties such as creditors who reasonably rely upon information provided by the lender.[22]

This article surveys the legal theories relied upon by borrowers and creditors in recent lender liability cases. The article is divided into two parts: Part I focuses on theories utilized by borrowers; Part II focuses on theories asserted by unsecured creditors. Each section analyzes the leading lender liability cases, including pertinent Mississippi decisions, and comments on the applicability of the particular lender liability theory under Mississippi law. The authors conclude that Mississippi courts should not rush to embrace the so-called "emerging theories of lender liability." Lenders ordinarily should be permitted to enforce their loan agreement as written; legal theories that impose ambiguous limitations on lenders' ability to rely on the express terms of their loan agreements should be rejected.

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[12] *See infra* note 36.

[13] *See infra* notes 196-214, 385-407 and accompanying text.

[14] *See infra* notes 215-238 and accompanying text.

[15] *See infra* notes 91-176, 349-384 and accompanying text.

[16] *See infra* notes 23-90 and accompanying text.

[17] *See infra* notes 239-274, 430-441 and accompanying text.

[18] *See infra* notes 211-214 and accompanying text.

[19] *See infra* notes 152-176 and accompanying text.

[20] *See infra* notes 84-88 and accompanying text.

[21] *See infra* notes 160-166 and accompanying text.

[22] *See infra* notes 408-429 and accompanying text.

I. Borrower Theories

A. *Breach of the Implied Covenant of Good Faith*

Most American jurisdictions agree that every contract contains an implied covenant of good faith.[23] A common law obligation of "good faith and fair dealing" is recognized by the Restatement (Second) of Contracts.[24] Recognition of the covenant of good faith is mandatory in transactions governed by the Uniform Commercial Code (U.C.C.).[25] In some jurisdictions, breach of this covenant may result in the imposition of tort as well as contractual liability.[26]

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[23] *See* Burton, *Breach of Contract and the Common Law Duty to Perform in Good Faith*, 94 Harv. L. Rev. 369, 404 app. (1980)(collection of cases from various jurisdictions).

[24] Restatement (Second) of Contracts § 205 (1979).

[25] *See* U.C.C. § 1-203; Miss. Code Ann. § 75-1-203 (1972)("Every contract or duty within this code imposes an obligation of good faith in its performance or enforcement."); *see, e.g., Commercial Cotton Co. v. United California Bank*, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551, 554 (1985)(liability imposed on bank for breach of duties of good faith for refusing to recredit customer's account after payment of check with unauthorized signatures). *See generally* Burke, *Emerging Theories*, *supra* note 11, at 473-520 (discussion of UCC provisions of good faith and fair dealing); Kitada, *Emerging Theories of Bank Liability - The Breach of the Covenant of Good Faith and Fair Dealing*, 103 Banking L.J. 80 (1986)(same).

[26] A number of jurisdictions permit recovery in tort for bad faith breach of an insurance contract. *See* S. Ashley, Bad Faith Actions: Liability and Damages § 2:05 at 9, 10 n.1 (1984)(cataloging cases). Most courts have refused to extend this tort to other commercial contracts. *Id.* § 11.03 n. 1 (listing cases); *see, e.g.*, Betterton v. First Interstate Bank, 800 F.2d 732, 736 (8th Cir. 1986)(lender liability case); Carrico v. Delp, 141 Ill. App. 3d 684, 490 N.E. 972, 977 (1986)(same). However, some jurisdictions, most notably California and Montana, have extended the bad faith tort doctrine to employment contracts, *e.g.*, Smithers v. Metro-Goldwyn-Mayer Studios, Inc., 139 Cal. App. 3d 643, 189 Cal. Rptr. 20, 23-24 (1983); Gates v. Life of Montana Ins. Co., 205 Mont. 304, 668 P.2d 213, 214 (1983); bank deposit contracts, *e.g.*, Commercial Cotton Co. v. United Cal. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551, 554-55 (1985); First Nat'l Bank v. Twombly, 689 P.2d 1226, 1230 (Mont. 1984); loan agreements, *e.g.*, Barrett v. Bank of Am., 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16, 20-21 (1986); Noonan v. First Bank, 740 P.2d 631, 635 (Mont. 1987); and certain other kinds of offensive business conduct, *e.g.*, Seaman's Direct Buying Serv. v. Standard Oil Co., 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354, 362-63 (1984)(denying existence of contract); Nicolson v. United Pacific Ins. Co., 710 P.2d 1342, 1347 (Mont. 1985)(malicious conduct). The Montana Supreme Court's approach is detailed in Comment, *Commercial Bad Faith: Tort Recovery for Breach of Implied Covenant in Ordinary Commercial Contracts*, 48 Mont. L. Rev. 349 (1987). For a persuasive criticism of this tort, see Comment, *Tort Remedies for Breach of Contract: The Expansion of Tortious Breach of the Implied Covenant of Good Faith and Fair Dealing Into the Commercial Realm*, 86 Colum. L. Rev. 377 (1986). For a con-

The duty of good faith creates troubling issues for lenders. Initially, "good faith" conduct must be distinguished from "bad faith" conduct. Courts disagree whether good faith requires pure motives, commercial reasonableness or both. Many of the cases focus on section 1-208 of the U.C.C., which provides that a contract clause permitting acceleration of a loan "at will" or when a lender deems itself "insecure", is enforceable only if the lender "in good faith believes that the prospect of payment or performance is impaired."[27] One line of cases holds that the test for good faith under this section is whether the lender "honestly believes" its prospects of payment are impaired.[28] This view, some-

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trary view, see Comment, *Seaman's Direct Buying Service, Inc. v. Standard Oil Co.: Tortious Breach of the Covenant of Good Faith and Fair Dealing in a Noninsurance Commercial Contract Case*, 71 IOWA L. REV. 896, 905-10 (1986)(advocating recognition of tort liability by Iowa courts); Comment, *Lenders' Liability - The Shift From Contract to Tort Doctrine Deters Banks From Enforcing Unjustified and Detrimental Contract Provisions*, 21 J. MARSHALL L. REV. 372, 383-85 (1988)(advocating imposition of tort liability against banks).

Tort liability was imposed on a lender for negligently processing a loan application in Jacques v. First Nat'l Bank, 307 Md. 527, 515 A.2d 756 (1986). The duty breached was an implied covenant of reasonable care imposed on the lender by public policy. *Id.* at 759-60. For a critical review of *Jacques*, see Ellis & Gray, *Lender Liability For Negligently Processing Loan Applications*, 92 DICK. L. REV. 363 (1988).

Mississippi permits the recovery of tort damages when a breach of contract is attended by such intentional wrongdoing or gross negligence as to amount to an independent intentional tort for which punitive damages may be recoverable. *See* Fedders Corp. v. Boatright, 493 So. 2d 301, 311 (Miss. 1986)(recognizing punitive damages may be recovered for tortious breach of contracts governed by U.C.C.). Most of the reported cases involve claims against insurance companies. Until recently the Mississippi Supreme Court indicated the standard for imposing tort liability on an insurance contract was no different from the standard applicable to other types of contracts. *See, e.g.*, Reserve Life Ins. Co. v. McGee, 444 So. 2d 803, 807 (Miss. 1984)(criticizing use of the term "bad faith"). However, in Blue Cross & Blue Shield of Miss., Inc. v. Maas, 516 So. 2d 495 (Miss. 1987), a majority of the court joined in a special concurrence by Judge Robertson recognizing "the tort of bad faith refusal to pay timely a legitimate [insurance] claim" for which "ordinary tort damages" for economic loss (including attorney's fees) and emotional distress damages could be awarded. *Id.* at 498. The concurrence implied these damages would have been recoverable, even if the circumstances did not justify the imposition of punitive damages. For Judge Robertson's views on this subject, see his concurrence in Pioneer Life Ins. Co. v. Moss, 513 So. 2d 927, 931 (Miss. 1987) and his dissent in Blue Cross & Blue Shield of Miss., Inc. v. Campbell, 466 So. 2d 833, 850 (Miss. 1984). It is unclear whether the Mississippi Supreme Court will extend this bad faith tort concept outside the insurance context.

[27] U.C.C. § 1-208; MISS. CODE ANN. § 75-1-208 (1972).

[28] *See, e.g.*, Ginn v. Citizens and Southern Nat'l Bank, 145 Ga. App. 175, 243 S.E.

times referred to as "the pure heart and empty head" standard,[29] is consistent with section 1-201 of the U.C.C., which defines "good faith" as "honesty in fact."[30] Another line of cases holds that a lender's belief that its prospect of payment is impaired must be commercially reasonable, as well as honest.[31] This view, which amounts to a negligence standard, is supported by a comment to the Restatement (Second) of Contracts, which states that good faith and fair dealing require adherence to "*community standards* of decency, fairness or reasonableness."[32]

An even more troubling issue is the relation, or lack thereof, between the implied duty of good faith and the express rights and obligations contained in the parties' loan agreement. Here

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2d 528, 530 (1978)(issue is whether lender acted honestly); Van Horn v. Van De Wol, Inc., 6 Wash. App. 959, 497 P.2d 252, 253 (1972)("negligence irrelevant to good faith" under U.C.C.). One court approved the following jury instruction regarding the U.C.C. duty of good faith: "Good faith means that one acts without any improper motivation. One acts with the truth and not for some ulterior motive that is unconnected with the substance of the agreement in question when one is acting in good faith." Reid v. Key Bank of Southern Maine, Inc., 821 F.2d 9, 15 (1st Cir. 1987)(upholding jury verdict for actual, punitive damages for breach of duty of good faith in U.C.C. §§ 1-203, 208). A fundamental problem with this definition is the implication that "any improper motivation" is sufficient to impose liability. The mere existence of an improper purpose should not be considered bad faith so long as an actor's primary motivation is legitimate. *See* RESTATEMENT (SECOND) OF TORTS § 769(d)(1979)(conditional privilege to interfere with prospective business relation if purpose is at least in part to advance actor's competitive interest).

[29] Black v. Peoples Bank and Trust Co., 437 So. 2d 26, 29 (Miss. 1983).

[30] U.C.C. § 1-201 (19); MISS. CODE ANN. § 75-1-201 (19)(1972).

[31] *See, e.g.*, Sheppard Fed. Credit Union v. Palmer, 408 F.2d 1369, 1370-71 (5th Cir. 1969)(applying objective test).

[32] RESTATEMENT (SECOND) OF CONTRACTS § 205 comment a (1979). The Reporters' comment to the Restatement states that the obligation of good faith and fair dealing "may require more than honesty." RESTATEMENT (SECOND) OF CONTRACTS § 205 comment d (1979). The comment catalogs the following examples of bad faith: "Evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance." *Id.* at comment d. For other views on the problem of distinguishing good faith from bad faith, see Burton, *supra* note 23 at 505 (bad faith is using discretionary contract authority to recapture opportunities lost as result of entering contract); Stankiewicz, *Good Faith Obligation in the Uniform Commercial Code: Problems in Determining and Evaluating its Effect*, 7 VAL. U. L. REV. 389, 400 (1973)(define by bootstrapping on earlier courts' finding of bad faith); Summers, *"Good Faith" in General Contract Law and the Sales Provisions of the Uniform Commercial Code*, 54 VA. L. REV., 195, 199-200 (1968)(cannot be defined other than as excluder of bad faith).

the question is whether a lender's subjective or objective "good faith" matters at all if the loan agreement authorizes the lender's action.[33] Initially, courts used the covenant of good faith to determine the intent of the parties when the contract was silent about a particular matter.[34] Over time, however, some courts began to use the covenant to limit the exercise of contract rights that offended the court's view of fairness.[35]

Lenders have been held liable for breach of the duty of good faith for failing to honor loan commitments,[36] refusing to make loan advances[37] and for improper acceleration of due dates.[38] In

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[33] T. Quinn, *Uniform Commercial Code Commentary and Law Digest* § 1-208[A][1] (Supp. 1986).

[34] *See, e.g.*, Riess v. Murchison, 503 F.2d 999, 1001, 1012 (9th Cir. 1974), (finding implied covenant to endeavor in good faith to produce, save, sell water), *cert. denied*, 420 U.S. 993 (1975); Wood v. Lucy, Lady Duff-Gordon, 222 N.Y. 88, 118 N.E. 214, 214 (1917)(implied duty to use reasonable efforts in performance of contract).

[35] *See, e.g.*, K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 760 (6th Cir. 1985)(refusal to make discretionary loan advances); Neumillar Farms v. Cornett, 368 So. 2d 272, 275 (Ala. 1979)(buyer may reject goods based on claim of dissatisfaction only in good faith).

[36] *See, e.g.*, 999 v. C.I.T. Corp., 776 F.2d 866, 872 (9th Cir. 1985)(breach of binding written commitment). The implication of a duty of good faith can sometimes assist lenders in enforcing commitments. *See, e.g.*, Teachers Ins. & Annuity Ass'n v. Butler, 626 F. Supp. 1229, 1235-36 (S.D. N.Y. 1986)(putative borrowers' breach of written loan commitment). These decisions are troubling in that the same result probably could have been reached without reliance on an ambiguous implied duty of good faith. For instance, in Shaughnessy v. Mark Twain State Bank, 715 S.W. 2d 944 (Mo. Ct. App. 1986), the court found that, absent default, a line of credit was a commitment to lend the full amount of the authorized credit because a commitment fee had been paid and the parties had agreed on a definite expiration date. *Id.* at 953-55. In so holding, however, the court refused to find breach of an implied covenant of good faith. *Id.* at 953; *see also* Landes Const. Co., Inc. v. Royal Bank, 833 F.2d 1365, 1368-69 (9th Cir. 1987)(oral commitment partially performed); National Farmers Org., Inc. v. Kinsley Bank, 731 F.2d 1464 (10th Cir. 1984)(breach of commitment); Sterling Faucet Co. v. First Mun. Leasing Corp., 716 F.2d 543, 544 (8th Cir. 1983)(same); Penthouse Int'l v. Dominion Sav. & Loan Ass'n, 665 F. Supp. 301, 309-11 (S.D. N.Y. 1987)(breach of written commitment); Consolidated American Life Ins. Co. v. Covington, 297 So. 2d 894, 898 (Miss. 1984)(holding issue of whether borrower had complied with conditions of commitment was jury question).

[37] *See, e.g.*, Reid v. Key Bank, Inc., 821 F.2d 9, 12-15 (1st Cir. 1987)(termination of line of credit agreement); K.M.C. Co. v. Irving Trust Co., 757 F.2d 752, 760 (6th Cir. 1985)(good faith limitation on right to refuse advances without notice); Ricci v. Key Bancshares of Maine, Inc., 662 F. Supp. 1132, 1141 (D. Me. 1987)(termination of line of credit agreement); Carrico v. Delp, 141 Ill. App. 3d 684, 490 N.E. 2d 972, 976 (1986)(same).

[38] *See, e.g.*, Betterton v. First Interstate Bank, 800 F.2d 732, 733-35 (8th Cir. 1986)(acceleration of note despite oral agreement to extend); Brown v. Avemco Investment Corp., 603 F.2d 1367, 1375-79 (9th Cir. 1979)(acceleration for technical default

some of these cases, the courts extended section 1-208 of the U.C.C., which expressly applies only to acceleration when a lender deems itself insecure, to lenders' refusal of discretionary loan advances and to demand notes.

The best known of these cases is *K.M.C. Co. v. Irving Trust Co.*,[39] a federal appellate decision upholding a 7.5 million dollar jury verdict against a lender for destruction of its borrower's business.[40] The parties' financing agreement provided that Irving Trust could loan, in its discretion, "up to" an agreed credit line and "up to" a certain maximum percentage of K.M.C.'s accounts receivable and inventory.[41] Repayment was due on demand.[42] To secure repayment, K.M.C. agreed to deposit the proceeds from its receivables into a "blocked account" over which Irving Trust had exclusive control. This arrangement left K.M.C. wholly dependent upon Irving Trust for operating funds.[43] Over a three year period, the parties developed a course of dealing in which Irving Trust would advance funds under the line-of-credit to cover K.M.C.'s outstanding checks.[44]

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where lender was fully secured); Layne v. Fort Carson Nat'l Bank, 655 P.2d 856, 857-58 (Colo. Ct. App. 1982)(enforcement of due-on-sale clause where lender secured); Universal C.I.T. Credit Corp. v. Sheperd, 164 Ind. App. 516, 329 N.E. 2d 620, 623-24 (1975)(applying objective test in action for conversion of seized collateral); First Nat'l Bank v. Twombly, 689 P.2d 1226, 1229-30 (Mont. 1984)(seizure of collateral after oral agreement to extend loan); *cf.* Sahadi v. Continental Ill. Nat'l Bank & Trust Co., 706 F.2d 193, 196-97 (7th Cir. 1983)(acceleration for nonmaterial breach when note payment only one day late).

[39] 757 F.2d 752 (6th Cir. 1985).

[40] *Id.* at 766.

[41] *Id.* at 754.

[42] *Id.* at 760. Neither the demand provision nor the parties' agreement was quoted in the court's opinion. At least one commentator has suggested the loan documents did not contain an unconditional right of demand. *See* Warren, *Good Faith and Fair Dealing Under the Uniform Commercial Code*, I ABA EMERGING THEORIES OF LENDER LIABILITY 57, 67-68 (H. Chaitman ed. 1985)(financing agreement inconsistently provided for 60 days notice of termination of agreement). [As several articles from this particular publication, volumes I, II, and III, will be referred to herein, the publication will be hereinafter cited as ABA.]

[43] *K.M.C. Co.*, 757 F.2d at 759. The court recognized that the power afforded Irving Trust by the terms of the financing agreement and the blocked account arrangement left "K.M.C.'s continued existence entirely at the whim or mercy of Irving, absent an obligation of good faith performance." *Id.*

[44] The trial court's memorandum denying Irving's motion for J.N.O.V. notes that "the parties had established a pattern of doing business under the Financing Agreement

K.M.C. began to experience financial problems and requested a $500,000 increase in its credit line. One week later, K.M.C. asked Irving Trust to advance the balance of its credit limit to cover overdrafts. Although fully secured, Irving Trust refused to make the requested advance.[45] K.M.C.'s checks were dishonored, and despite later advances by Irving Trust, K.M.C.'s business was destroyed.[46]

Evaluating the *K.M.C. Co.* decision is difficult because the opinion contains contradictory findings. The court held that Irving Trust had a good faith obligation to give K.M.C. notice and an opportunity to secure alternative financing before exercising its discretion not to make further advances, absent a "valid business reason precluding Irving Trust from doing so."[47] Paradoxically, the court also held that the duty of good faith limited Irving Trust's discretionary authority to refuse further loans and to demand payment of funds already advanced.[48]

The court gleaned its notice rule from a nineteenth century New York decision[49] and from the commentary to section 2-309 of the U.C.C., which applies to the termination of sales contracts with indefinite durations.[50]

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whereby Irving Trust would transfer funds to cover outstanding checks in K.M.C.'s account at Park National Bank in accordance with formulas established by quarterly audits of K.M.C. by Irving Trust, and when requests for such transfers were made by K.M.C." *K.M.C. Co. v. Irving Trust Co.*, No. Civ-3-82-365 (E.D. Tenn. 1983), *reprinted in* I ABA 83, 83-100.

[45] *K.M.C. Co.*, 757 F.2d at 762.

[46] *Id.* at 754, 762.

[47] *Id.*

[48] *Id.* "There is ample evidence in the record to support a jury finding that no reasonable loan officer in the same situation would have refused to advance funds to K.M.C. without notice." *Id.*; *see* In re Red Cedar Constr. Co., 63 Bankr. 228, 237 (Bankr. W.D. Mich. 1986)(construing *K.M.C. Co.*). A personality conflict between K.M.C.'s president and a loan officer may have partially motivated Irving Trust's actions. *K.M.C. Co.*, 757 F.2d at 761.

[49] *See* Wells v. Alexandre, 130 N.Y. 642, 29 N.E. 142, 143 (1891)(imputing notice provision as gap filler in requirements contract), *cited in K.M.C. Co.*, 757 F.2d at 759. The *K.M.C. Co.* court cited *Wells* for the proposition that any construction of the contract that would place one of the parties entirely at the mercy of the other party is unreasonable and that a covenant to give notice will be implied in such situations. *See infra* notes 379-384 and accompanying text.

[50] *K.M.C. Co.*, 757 F.2d at 759. U.C.C. § 2-309 provides that termination of a contract other than by an agreed event requires reasonable notice and that an agreement waiving notice is invalid if its operation would be unconscionable. Comment 8 to this

The court relied upon section 1-208 of the U.C.C. in placing a good faith limitation on Irving Trust's discretion to make further advances and to demand payment of loans.[51] To support this reliance, the court cited *Brown v. Avemco Investment Corp.*,[52] a frequently criticized decision of the Ninth Circuit, which held that section 1-208 precludes acceleration for default — as well as for insecurity —unless the lender concludes, in good faith, that its prospects for payment are impaired.[53]

In *K.M.C. Co.*, Irving Trust argued that the test for good faith under section 1-208 was whether its loan officer honestly believed he had a valid reason for not making further advances to K.M.C. The court disagreed, reasoning that good faith requires "some objective basis" from which a "reasonable loan officer" would conclude that funds should be refused.[54] Since Irving Trust was fully secured, the court concluded that K.M.C.'s financial difficulties were insufficient justification for refusing further advances.[55]

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section, which was quoted by the *K.M.C. Co.* court, states: "[T]he application of principles of good faith and sound commercial practice normally call for such notification of the termination of a going contract relationship and will give the other party reasonable time to seek a substitute arrangement." U.C.C. § 2-309 comment 8.

MISS. CODE ANN. § 75-2-309 is consistent with the common law rule that contracts of an indefinite duration can be cancelled only upon reasonable notice. *See* First Miss. Bank of Commerce v. Latch, 433 So. 2d 946, 950 (Miss. 1983)(reasonable notice must be given before terminating contract with indefinite duration). We suggest, however, that this rule has no application when the parties' agreement unconditionally permits termination by making demand, since by definition a demand note is payable at anytime after it is executed.

[51] *K.M.C. Co.*, 757 F.2d at 759.

[52] 603 F.2d 1267 (9th Cir. 1979), *cited in K.M.C. Co.*, 757 F.2d at 760.

[53] *Brown*, 603 F.2d at 1379. The action arose when a lender enforced a due-on-lease clause which permitted acceleration for default if the borrower leased an airplane securing a loan without the consent of the lender. The lender knew about the lease but nevertheless accepted payments from the lessees for 23 months before the lender accelerated. *Id.* at 1375. The court held that U.C.C. § 2-208 applied because the default provision made acceleration enforceable at the lender's option. *Id.* at 1379. The court also held that Texas imposes a common law limitation of reasonableness on the acceleration and cited with approval cases in other jurisdictions refusing to enforce due-on-sale clauses in mortgages on equitable grounds. *Id.* at 1379-80.

[54] *K.M.C. Co.*, 757 F.2d at 761.

[55] *Id.* Other factors relied upon by the court included:

(1) an admission by one of Irving's officers that he would not have been acting in good faith to refuse to advance funds to K.M.C. without notice if he believed Irving was adequately secured;

In sum, the *K.M.C. Co.* court used the covenant of good faith to graft a notice requirement into a demand loan and to limit the discretionary power given the lender under the loan agreement in making advances and requiring repayment of advances.

Admittedly, the lender's conduct reported in *K.M.C. Co.* was egregious. However, the court could have reached the same result by applying less radical contract principles. Most courts recognize that a lender may waive its contractual rights or be estopped from enforcing them by engaging in a course of conduct inconsistent with the contractual rights sought to be enforced. A finding of waiver or estoppel would have been supported by the facts reported in *K.M.C. Co.*[56] and would have

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(2) testimony by a local banker that any reasonable banker evaluating the loan would have agreed it was fully secured;

(3) testimony by an attorney for another food wholesaler interested in purchasing K.M.C. that in a telephone conversation the loan officer acknowledged that Irving was adequately secured, that he knew terminating financing would destroy K.M.C., and that he would advance the funds requested by K.M.C. to give the attorney an opportunity to evaluate possible acquisition of K.M.C. (later, the loan officer changed his mind);

(4) Irving's advancement of funds in an amount in excess of $700,000 after March 1 to try to prop up K.M.C. until it could be sold.

Id. at 761-62.

[56] The trial court partially relied upon the doctrine of waiver in rejecting K.M.C.'s motion for judgment N.O.V. Specifically, the court held that the law will not permit one party to a contract to strictly enforce covenants in a contract when the parties' past dealings have created the impression the covenants will not be enforced, unless notice of a change in intentions is given. *K.M.C. Co.*, No. Civ-3-82-365 (E.D. Tenn. 1983) *reprinted in* I ABA 83, 83-101. Relying on U.C.C. § 2-208, courts have almost uniformly held that a lender may not habitually accept late payments, then attempt to declare default because a payment is late without first giving the debtor notice of an intent to strictly enforce the contract. *See, e.g.*, Nevada Nat'l Bank v. Huff, 94 Nev. 506, 582 P.2d 364, 369-70 (1978)(acceptance of late payments); Knittel v. Security State Bank, 593 P.2d 92, 95-96 (Okla. 1979)(same); Lee v. Wood Prod. Credit Union, 551 P.2d 446, 448 (Or. 1976)(same). Courts disagree on the enforceability of contract clauses which provide that the lender's waiver of one or more defaults does not constitute a waiver of later defaults. Some courts have held that anti-waiver clauses preclude modification or waiver through course of performance or dealing. *See, e.g.*, Hale v. Ford Motor Credit Co., 374 So. 2d 849, 853 (Ala. 1979)(under nonwaiver acceleration, nonmodification clauses, no notice required of secured party to take possession of collateral); Van Bibber v. Morris, 275 Ind. 555, 419 N.E. 2d 115, 121 (1981)(same). Other courts have held that antiwaiver clauses can be modified or waived at least to the extent of obligating the lender to give notice of its intent to strictly enforce the parties' contract. *See, e.g.*, Westinghouse Credit Corp. v. Shelton, 645 F.2d 869, 873 (10th Cir. 1981)(citing cases). *But see, Van Bibber*, 419 N.E.2d at 121 ("We consider this approach to be illogical, since the very conduct

yielded the same result without reliance on ambiguous notions of good faith and fair dealing.

Following *K.M.C. Co.*'s lead, other courts have placed a good faith limitation on lenders' discretion to refuse loan advances. For instance, in *Yankton Production Credit Association v. Larson*,[57] the loan documents provided that advances under a line of credit would be "made at the option of the" lender, that "nothing . . . shall be construed to obligate the [lender] to make loans or advances" and that making advances was "in the absolute discretion" of the lender.[58] The Larsons claimed that the lender's refusal to make advances necessary to complete the expansion of their farm operations violated the implied covenant of good faith. The trial court entered summary judgment for the lender. On appeal, the Nebraska Supreme Court reversed because the record did not disclose whether the lender's refusal to make further advances "was based on a reasonable, good faith business judgment."[59]

Several recent decisions have refused to follow *K.M.C. Co.* In *Centerre Bank v. Distributors, Inc.*,[60] a Missouri appellate

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which the clause is designed to permit — acceptance of late payment — is turned around to constitute waiver of the clause permitting the conduct."). One of the more significant course of dealing cases is Alaska Statebank v. Fairco, 674 P.2d 288 (Alaska 1983). In *Fairco*, the security agreement provided that, if the debtor missed a payment, the lender could accelerate the note and take possession of the collateral securing the note without notice. *Id.* at 289. After the borrowers missed two payments, the parties entered into workout negotiations. During the course of those negotiations, the lender took possession of the collateral without giving notice to the borrower. *Id.* at 290. The court held that the negotiations had effectively modified the security agreement and upheld a verdict for the borrower. *Id.* at 291-93.

The Mississippi Supreme Court held that a lender's acceptance of late payments precluded strict enforcement of a loan agreement without prior notice in American Nat'l Bank & Trust Co. v. Byrd, 191 Miss. 457, 467-68, 3 So. 2d 850, 850-52 (1941). Significantly, the court permitted the borrower to recover punitive damages because it characterized the lender's conduct as reckless. *Id.* at 468, 3 So. 2d at 850. The court refused to enforce a provision requiring all contract modifications be in writing in City of Mound Bayou v. Roy Collins Constr., 499 So. 2d 1354, 1357-59 (Miss. 1986). *But see* Delta Loan & Finance Co. v. Craven, 231 Miss. 203, 205, 95 So. 2d 105, 105-06 (1957)(enforcing non-waiver provision).

[57] 219 Neb. 610, 365 N.W.2d 430 (1985).

[58] *Id.* at 432.

[59] *Id.* at 434; *see also* Carrico v. Delp, 141 Ill. App. 3d 684, 490 N.E.2d 972, 976 (refusal to lend under discretionary line of credit).

[60] 705 S.W.2d 42 (Mo. Ct. App. 1985).

court refused to recognize a good faith limitation on a lender's right to call a demand note evidencing a line of credit the bank had granted Distributors, Inc. The note was guaranteed by Mr. and Mrs. Brown, who bought stock in Distributors, Inc. after a loan officer assured them the bank would continue financing the corporation's operations.

Shortly after the Browns purchased their stock, the bank called the demand note.[61] Distributors, Inc. defaulted and Centerre Bank sued to recover a deficiency from the corporation and the Browns.[62] Relying upon *K.M.C. Co.*, the Browns counterclaimed, contending the bank had accelerated the note in bad faith and thereby violated section 1-208 of the U.C.C. The jury returned a verdict for actual and punitive damages against the bank.[63]

On appeal, the verdict was reversed because the note was payable "on demand." The court concluded that a demand instrument could be called for whatever reason the lender desired, good or bad, since reading a duty of good faith into the loan agreement added "a term to the agreement which the parties had not included."[64]

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[61] *Id.* at 44.

[62] *Id.* at 46.

[63] *Id.* at 44.

[64] *Id.* at 47, *citing* Fulton Nat'l Bank v. Willis Denney Ford, Inc., 154 Ga. App. 846, 269 S.E.2d 916 (1980) and Allied Sheet Metal Fabricators, Inc. v. Peoples Nat'l Bank, 10 Wash. App. 530, 518 P.2d 734 (1974), *cert. denied*, 419 U.S. 967 (1974). The court noted that "there was no reason why the obligor on a demand instrument should be entitled to contest the holder's decision to enforce payment when the obligor, by his signature has agreed that his obligation is immediately due and payable." *Centerre Bank*, 705 S.W.2d at 47. The court also noted: "The parties by the demand note did not agree that payment would be made only when demand was made in good faith but agreed that payment would be made whenever demand was made." *Id.* at 48.

Lenders should be aware, however, that the type of demand note construed in *Centerre Bank* has been narrowly construed by other courts. U.C.C. § 3-108 defines demand instruments to "*include* those payable on sight or on presentation and those in which no time for payment is stated." U.C.C. § 3-108 (emphasis supplied). When the loan documents contain provisions suggesting that the requirement of payment is contingent upon events other than demand, such as a provision providing for acceleration upon certain events of default, some courts have held the note is not a demand instrument and that U.C.C. § 1-208 is applicable. For instance, in Reid v. Key Bank of Southern Maine, Inc., 821 F.2d 9 (1st Cir. 1987), the court held that § 1-208 applied to termination of a $25,000 line of credit evidenced by a demand note for $25,000 because (i) the entire $25,000 had not been drawn, so the face amount of the note could not be due on de-

Centerre Bank's logic was applied by a Florida appellate court in *Flagship National Bank v. Gray Distribution Systems, Inc.*[65] In *Flagship National Bank*, the parties entered into a workout agreement which provided a line of credit to Gray. As in *Centerre Bank*, the line of credit was evidenced by a demand note. To secure repayment, the agreement required that Gray's operating revenues be deposited into a bank account; the funds deposited into this account were applied against the outstanding loan balance. Gray could not disburse funds from this account without the approval of the bank.[66]

The bank indirectly increased Gray's credit over the ceiling established by the work out agreement by giving Gray's suppliers letters of credit. When Gray's sales declined, the bank refused to issue further letters of credit and insisted that Gray liquidate some of its assets in order to reduce its indebtedness. This liquidation, combined with restrictions on further borrowing, caused Gray's business to deteriorate further. Eventually, the bank called the demand note.[67]

The trial court found that the parties had modified the workout agreement through their course of dealing and that the lender had violated section 1-208 of the U.C.C. by accelerating

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mand, (ii) the security agreement provided for acceleration upon the occurrence of events of default, (iii) the note contained provisions governing the acceleration of payment or termination which would "render" the note "payable on demand", and (iv) a bank officer admitted the line-of-credit could not be terminated precipitously. *Id.* at 13-14; *see also* Shaughnessy v. Mark Twain State Bank, 715 S.W.2d 944, 951-52 (Mo. Ct. App. 1986)(references to maturity of note in loan documents, typewritten due date on one note, provision for acceleration on default precludes finding note is payable on demand). A middle course was adopted by the court in Spencer Companies, Inc. v. Chase Manhattan Bank, 81 Bankr. 194 (Bankr. D. Mass. 1987)(applying New York law). There the court observed that a pure demand note under U.C.C. 3-108 is immediately payable upon execution without the necessity of a formal demand for payment. However, when the terms of the demand note evidence the debt is not due until a later date (such as a provision providing for the payment of interest at one rate until maturity and then a different rate thereafter), the note is not due until a formal demand for payment is made. Significantly, the court emphatically rejected the borrower's argument that the bank's right to make this formal demand was subject to the obligation of good faith and fair dealing. *Id.* at 198-99.

[65] 485 So. 2d 1336 (Fla. Dist. Ct. App. 1986).

[66] *Id.* at 1338.

[67] *Id.* at 1339.

the note in bad faith.[68] The appellate court rejected the trial court's application of section 1-208 because the note was payable on demand. As in *Centerre Bank*, the court reasoned that an implied obligation of good faith "may not be imposed to override express terms in the [parties'] contract."[69]

Both *Centerre Bank* and *Flagship National Bank* distinguished and criticized *K.M.C. Co.* The court in *Centerre Bank* suggested that *K.M.C. Co.* was limited to situations in which credit was revoked suddenly and without notice.[70] *Flagship National Bank* pointedly criticized *K.M.C. Co.*'s extension of section 1-208 to demand notes and distinguished *K.M.C. Co.* on the basis that a duty to give notice had arisen during the course of dealing between K.M.C. and Irving Trust.[71]

The remedial scope of the duty of good faith under Mississippi law has not been fully defined. Most loan agreements are subject to the Mississippi U.C.C.,[72] which mandates implication of a covenant of good faith.[73] In *Black v. Peoples Bank & Trust*

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[68] *Id.* at 1339-40.

[69] *Id.* at 1340; *see also* Brighton Dev. Corp. v. Barnett Bank of South Fla., N.A., 513 So. 2d 1103, 1104 (Fla. Dist Ct. App. 1988)(no bad faith in refusing to refund commitment fee since no contractual obligation to extend time for preparing loan documents). A relevant pre-*K.M.C. Co.* case is Lambert v. Maryland Casualty Co., 418 So. 2d 553 (La. 1982). In *Lambert*, the court rejected a contractor's claim that a surety financing the contractor's operations had breached its duty of good faith by refusing, without reasonable notice, to make advances under its loan agreement. *Id.* at 561. The court observed that the loan agreement expressly reserved the surety's right to refuse requests for additional advances and held that good faith did not require the surety "to forbear in the exercise of its rights, contracted at arms length, for its own protection against further liability and loss." *Id.* For an in-depth analysis of *Lambert* and the special legal questions involved in surety financing of their principal's operations, see generally Sneed & Athay, *Ramifications for the Surety-Domination Revisited*, ABA FIDELITY AND SURETY LAW COMMITTEE, CURRENT LEGAL AND ETHICAL SURETYSHIP ISSUES (Jan. 29, 1988), and Schroeder, *Providing Financial Support to the Contractor*, XVII FORUM 1190 (1982).

[70] *Centerre Bank*, 705 S.W.2d at 48.

[71] *Flagship National Bank*, 485 So. 2d at 1341; *see also* Taggart & Taggart Seed, Inc. v. First Tennessee Bank, No. H-C-87-18 (E.D. Ark. April 15, 1988)(1988 WL 35676)(refusing to impose a good faith limitation on a lender's right to make discretionary advances and call a note on demand); Spencer Companies, Inc. v. Chase Manhatten Bank, 81 Bankr. 194, 199 (D. Mass. 1987)(*K.M.C. Co.* misconstrued New York law applicable to demand notes).

[72] MISS. CODE ANN. § 75-1-101 *et seq.* (1972). Article 3 of the Uniform Commercial Code governs transactions in commercial paper, *Id.* § 75-3-202 *et seq.*, and Article 9 governs secured transactions, *Id.* § 75-9-101 *et seq.*

[73] *Id.* at § 75-1-203; *see* Wander, Ltd. v. Krouse & Co., 368 So. 2d 235, 237 (Miss.

Co.,[74] the Mississippi Supreme Court adopted the objective test for measuring good faith under section 1-208 of the U.C.C., which applies when a lender accelerates payment under an insecurity clause.[75] Accordingly, it is clear that under Mississippi law a lender may not accelerate payment of a loan under an insecurity clause unless the lender has a commercially reasonable basis for concluding that its security is impaired.

The Mississippi Supreme Court has not extended the reach of section 1-208 to demand notes, default accelerations or refusals to make discretionary loan advances. Doing so would be inconsistent with the language and intent of section 1-208[76] and with previous decisions of the court recognizing that the parties to a loan agreement are generally free to define the terms on which acceleration will be permitted. For instance, in *First National Bank v. Caruthers*,[77] the court held that a covenant permitting acceleration upon sale of mortgaged realty was enforceable, even if for a purpose other than protecting the lender's security interest in the property.[78] Thus, so long as the lender

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1979)(recognizing U.C.C. duty of good faith).

[74] 437 So. 2d 26 (Miss. 1983).

[75] *Id.* at 28-29. The court criticized the subjective test "because of the great latitude it gives the creditor and the onerous burden of proof it imposes on the debtor." *Id.* at 29. The court also noted that one of the drafters of the Code, Professor Gilmore, had written that an objective test was required. *Id.* (citing 2 G. GILMORE, SECURITY INTERESTS IN PERSONAL PROPERTY § 43.4 at 1197 (1965)). Finally, the court observed that Mississippi had applied an objective test in pre-code cases. *Id.* (quoting Commercial Credit Co. v. Cain, 190 Miss. 866, 871, 1 So. 2d 776, 777 (1941)).

[76] The official comment to the section makes it clear that the section is not intended to apply to instruments under which a lender has the discretion to accelerate for any reason: "Obviously this section has no application to demand instruments or obligations whose very nature *permits call at any time or for any reason.*" U.C.C. § 1-208 comment (emphasis supplied).

[77] 443 So. 2d 861 (Miss. 1983).

[78] *Id.* at 862. The issue before the court was the enforceability of a due-on-sale clause which permitted the lender to accelerate if the borrower sold the realty securing his loan. The court rejected the borrower's argument that this clause was unenforceable except for the purpose of protecting the lender's security interest in the project, reasoning: "The right of persons to contract is fundamental to our jurisprudence and absent mutual mistake, fraud and/or illegality, the courts do not have the authority to modify, add to, or subtract from the terms of a contract validly executed between the parties." *Id.* The court rejected an earlier decision, Sanders v. Hicks, 317 So. 2d 61 (Miss. 1975), which held that restrictions on alienation are unenforceable except to the extent necessary to protect the lenders' security interest. *Caruthers*, 443 So. 2d at 865. *See also* John-

deals honestly with the borrower, the U.C.C. duty of good faith should not impede enforcement of the express terms of a loan agreement, unless an insecurity clause is at issue.

Until recently it was unclear whether Mississippi imposed a common law obligation of good faith and fair dealing on contractual relationships. In a 1988 decision, *UHS-Qualicare, Inc. v. Gulf Coast Community Hospital, Inc.*,[79] the Mississippi Supreme Court recognized the duty of good faith and fair dealing espoused by the Restatement (Second) of Contracts.[80] Prior to that decision, Mississippi courts had imposed a common law duty of good faith only when a fiduciary relationship[81] or other special circumstances[82] existed between the contracting parties.[83]

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son v. Stinson, 418 So. 2d 805, 805-06 (Miss. 1982)(permitting acceleration for breach of covenant to obtain insurance); Universal C.I.T. Credit Corp. v. Rhodes, 237 Miss. 455, 462-63, 115 So. 2d 160, 163-64 (1959)(enforcement of pre-U.C.C. contract providing for acceleration upon default in payment). Other courts have rejected the application of § 1-208 to due-on-sale clauses, *e.g.*, Crockett v. First Federal Savings & Loan Ass'n of Charlotte, N.C., 289 N.C. 620, 224 S.E. 2d 580, 588 (1976), and other default acceleration provision; *see, e.g.*, Westland v. Melson, 647 S.W.2d 488, 490 (Ark. Ct. App. 1983).

[79] 525 So. 2d 746 (Miss. 1988).

[80] *Id.* at 757 n. 8. The issue in *UHS-Qualicare, Inc.*, was whether a material breach had occurred justifying termination of a contract for default when the terminating party had the power to cure the breach itself. *Id.* at 755. The court's reference to the duty of good faith was not essential to its holding.

[81] *See, e.g.*, Walker v. U-Haul Co. of Miss., 734 F.2d 1068, 1075 (5th Cir. 1984)(recognizing duty in a fiduciary relationship); Carter Equip. Co. v. John Deere Indus. Equip. Co., 681 F.2d 386, 392 (5th Cir. 1982)(same).

[82] The Mississippi Supreme Court had held that a contracting party must act in good faith when its duty to perform is contingent on its acceptance or rejection of the other party's performance. *See, e.g.*, Ford v. Lamar Life Ins. Co., 513 So. 2d 880, 887 (Miss. 1987)(determining compliance with conditions set forth in premium receipt for life insurance); City of Mound Bayou v. Roy Collins Constr., 499 So. 2d 1354, 1357-59 (Miss. 1986)(design professional must act in good faith in reviewing pay requests by contractor); *cf.* Ard Dr. Pepper Bottling Co. v. Dr. Pepper Co., 202 F.2d 372, 376 (5th Cir. 1953)(construing clause permitting termination if determination of non-compliance made in good faith). Lenders frequently must determine whether their borrowers have complied with condition precedents for making a loan or future advances under a loan. *See, e.g.*, Consolidated Am. Life Ins. Co. v. Covington, 297 So. 2d 894, 898 (Miss. 1984)(compliance for jury to decide).

In addition, the Mississippi Supreme Court had held that oil and gas operators under mineral leases have an implied duty to act as a prudent operator and to deal in good faith, fairly and equitably with royalty owners. Continental Oil Co. v. Blair, 397 So. 2d 538, 543 (Miss. 1981).

[83] Prior to *UHS-Qualicare, Inc.*, most authorities had concluded that Mississippi

Mississippi cases emphasize that the obligation of good faith and fair dealing does not limit a party's right to take action expressly authorized by its contract. Unless the contractual terms are unconscionable or illegal, even a fiduciary is entitled to enforce its contract as written and the duty of good faith yields to the rights granted by the agreement.[84] The application of this principle is illustrated by *Walker v. U-Haul Co.*[85] In *Walker*, the parties' franchise agreement permitted termination of the relationship, without cause, upon written notice. Despite the arguable existence of a fiduciary relationship between the parties, the court noted that the contract permitted termination for any reason and hence the duty of good faith did not preclude "act[ing] arbitrarily in terminating a business relationship . . . if arbitrariness is authorized by a contractual provision."[86] In so holding, the court apparently aligned Mississippi with the Texas rule —

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did not impose a common law duty of good faith and fair dealing on every contract relationship. Freeland & Freeland, *Bad Faith Litigation: A Practical Analysis*, 53 MISS. L.J. 237, 238 n.8 (1983)(under Mississippi law, duty to act in good faith "*does not apply to every contract*")(emphasis added); *see* Carter Equip. Co. v. John Deere Indus. Equip. Co., 681 F.2d 386, 392 n.12 (5th Cir. 1982)("Good faith and fair dealing are not customarily equated with a fiduciary duty. Mississippi, however, seems to merge the two concepts, at least in a broad sense."); Davidson v. State Farm Fire & Casualty Co., 641 F. Supp. 503, 514 (N.D. Miss. 1986)("[T]he Mississippi Court has not ruled on the existence of a duty of good faith and fair dealing *per se*," but has declined to impose the duty on nonfiduciaries.). There were scattered references to a general duty of good faith in other published Mississippi decisions, however. For instance, in Olin Corp. v. Central Industries, Inc., 576 F.2d 642 (5th Cir. 1979), the court referred to "the policy of Mississippi statutes requiring good faith and honesty in dealing." *Id.* at 648. The court cited to the good faith section of the Mississippi U.C.C. *Id.* at 648 n.9 (citing Miss. Code Ann. § 75-1-203 (1972)). The court also noted that Darden v. American Bank and Trust Co., 158 Miss. 742, 748, 130 So. 507, 509 (1930), cited 13 C.J. *Contracts* § 254 at 542-544 (1939) which states that every contract requires a covenant of good faith and fair dealing. *Olin Corp.*, 576 F.2d at 648 n.9. However, *Darden* did not quote, explain or otherwise rely on the cite for its holding. *See also*, Bank of Ind. v. Holyfield, 476 F.Supp. 104, 109 (S.D. Miss. 1979)(Mississippi law requires "good faith and fundamental fairness in the performance of every contract.")(dictum).

[84] *See* Jackson Rapid Delivery Serv., Inc. v. Jones Truck Lines, Inc., 641 F. Supp. 81, 85-86 (S.D. Miss. 1986)(contract definition of duties of parties supplants fiduciary duties of good faith and fair dealing unless contract unconscionable); *see also* Shaw v. Burchfield, 481 So. 2d 247, 252-54 (Miss. 1985)(enforcing clause in employment contract providing for termination upon 10 days notice without cause).

[85] 734 F.2d 1068 (5th Cir. 1984).

[86] *Id.* at 1075; *see also* Duncan v. Coahoma Bank, 397 So. 2d 891, 894 (Miss. 1981)(no liability for lender's allegedly tortious exercise of contract right).

"[t]here can be no implied covenant [of good faith] as to a matter specifically covered by the written terms of the contract."[87] Under this principle, the duty of good faith only regulates the conduct of the parties regarding matters the contract does not specifically address.[88]

Mississippi should continue to allow lenders to control their risks by negotiating loan agreements that empower them to take the steps necessary to salvage their losses when a loan goes sour.[89] Superimposing an ambiguous duty of fairness on the lenders' right to exercise its contractual powers would destroy the certainty and predictability of legal rights necessary for commercial loan transactions.[90]

B. Fiduciary Duty

A second theory used by borrowers to impose liability on lenders is the breach of fiduciary obligations. Commercial relationships ordinarily involve parties with competing interests. The parties deal at arms' length and admittedly watch out for their own interests. No party need place any other party's inter-

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[87] *See* Exxon Corp. v. Atlantic Richfield Co., 678 S.W.2d 944, 947 (Tex. 1984)(citation of Texas rule); *see also* McPherson v. Gullett Gin Co., 134 Miss. 771, 100 So. 16, 18 (1924)(if contract states duties and liabilities of parties, contract governs and no other duty is implied). Texas has adopted U.C.C. §§ 1-203 and 1-208, which require honesty in fact in the performance of contracts subject to its terms. TEX. BUS. & COM. CODE ANN. §§ 1.203, 1.208 (Vernon 1968). The Texas Supreme Court has refused, however, to recognize the RESTATEMENT (SECOND) OF CONTRACTS heightened duty of "good faith and fair dealing." *See* English v. Fischer, 660 S.W.2d 521, 522 (Tex. 1983)(All contracts do not contain "an implied covenant of 'good faith and fair dealing' that neither party will do anything which injures the right of the other party to receive the benefits of the agreement."); Tyler, *Emerging Theories of Lender Liability in Texas*, 24 HOUS. L. REV. 411, 423 (1987)("[T]he implied duty in Texas will be applied in interpreting contracts, but not to contradict the express terms of a contract."); W.F. Thompson v. M & B Constr. Corp., 585 F. Supp. 561, 563 (N.D. Tex. 1984)(same); *accord* Cluck v. First Nat'l Bank, 714 S.W.2d 408, 410 (Tex. Ct. App. 1986)(same).

[88] Tyler, *supra* note 87, at 418 (using duty of good faith to overcome express contract terms "calls into question the validity of all such contracts, while simultaneously depriving parties and their counsel of the guidance available from case law existing under traditional theories.").

[89] *See* Sneed & Athay, *supra* note 69, at 18.

[90] *Id.*; *see also* Warren, *supra* note 42, at 58 ("Good faith under the U.C.C. is a loose cannon and may be used by courts to further their view of justice.").

est above his own.[91]

Fiduciary relationships are different. A fiduciary acts for the benefit of others on matters within their relation.[92] When a conflict arises, the fiduciary must act in good faith to protect the other parties' interests, even at the expense of his own. Special duties of disclosure,[93] loyalty[94] and stewardship[95] spring from the relationship.[96]

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[91] *See* Haroco, Inc. v. American Nat'l Bank and Trust Co., 647 F.Supp 1026, 1035 (N.D. Ill. 1986)("The parties are businesses presumably dealing at arms length. Their relationships were governed by contracts. In short, they enjoyed no more than customary business relationships.")

[92] *See, e.g.*, Wright v. Bayly Corp., 587 P.2d 799, 801 (Colo. Ct. App. 1978)(citing RESTATEMENT (SECOND) OF TRUSTS § 2 comment b); Kurth v. Van Horn, 380 N.W.2d 693, 695 (Iowa 1986)(citing RESTATEMENT (SECOND) OF TORTS § 874 comment a)("fiduciary relation exists between two persons when one of them is under a duty to act for or to give advice for the benefit of another upon matters within the scope of the relation."); RESTATEMENT (SECOND) OF TRUST § 2 comment b (1959)(fiduciary is "under a duty to act for the benefit of the other as to matters within the scope of the relation."); RESTATEMENT (SECOND) OF TORTS § 874 comment a (1979).

[93] *See* RESTATEMENT (SECOND) OF TRUSTS § 170(2)(1959)(full disclosure required by fiduciary of all facts pertaining to transaction).

[94] The duty of loyalty embraces the concept that a fiduciary may not profit at the expense of his beneficiary and may not enter into competition with him without his consent. *See* RESTATEMENT (SECOND) OF TRUSTS § 2 comment b (1959)(discussion of duty of loyalty). The most widely quoted formulation of the duty of loyalty is contained in Chief Judge Cordoza's opinion in Meinhard v. Salmon, 249 N.Y. 458, 464, 164 N.E. 545, 546 (1928):

> Many forms of conduct permissible in a work a day world for those acting at arm's length, are forbidden to those bound by fiduciary ties. A trustee is held to something stricter than the morals of the market place. Not honesty alone, but the punctilio of an honor the most sensitive, is then the standard of behavior. As to this there has developed a tradition that is unbending and inveterate. Uncompromising rigidity has been the attitude of courts of equity when petitioned to undermine the rule of undivided loyalty by the 'disintegrating erosion' of particular exceptions. Only thus has the level of conduct for fiduciaries been kept at a level higher than that trodden by the crowd. It will not consciously be lowered by any judgment of this court.

Meinhard, 164 N.E. at 546. For a discussion of the duty of loyalty imposed upon directors and officers of corporations under Mississippi law, see Keker & Hunt, *Fiduciary Relationships in a Business Setting in Business Torts*, 38 MISS. L. INST. 25, 28-38 (1983).

[95] *See, e.g.*, First Alabama Bank v. Spragins, 475 So. 2d 512, 516 (Ala. 1985)(trustee has duty to exercise such care and skill as man of ordinary prudence would exercise; citing RESTATEMENT (SECOND) OF TRUSTS § 174); *see also* Wilcox v. St. Croix Labor Union Mut. Homes, Inc., 567 F. Supp. 924, 935 (D.C. V.I. 1983)(citing RESTATEMENT (SECOND) OF AGENCY § 379); Davis v. Miller Builders & Developers, Inc., 340 So. 2d 409, 413 (La. Ct. App. 1976)(same).

[96] *See* Note, *Trust and Confidence and the Fiduciary Duty of Banks in Iowa*, 35

Certain kinds of relationships are inherently fiduciary in nature. For this reason, attorneys, agents, trustees and partners are considered fiduciaries as a matter of law.[97]

Fiduciary relationships can also arise in commercial transactions if the circumstances justify making an exception to the usual rule that the parties to a commercial transaction must protect their own interests.[98] Although it is clear that mere friendship or confidence,[99] a good working relationship[100] or acting in an advisory capacity,[101] without more, does not create a fiduciary relationship, no single standard has been formulated for determining when the relationship actually arises.[102]

DRAKE L. REV. 611, 612 (1985-86)("Fiduciary breach generally takes one of three forms: breach of the duty of disclosure, loyalty or stewardship.").

[97] *See* J. POMEROY, EQUITY JURISPRUDENCE § 956(a) at 793-95 (5th ed. 1941)(analyzing categories of fiduciary relationships). One commentator reasoned that the court imposes fiduciary concepts in these kinds of relationships on a per se basis because "the factors that give rise to a fiduciary duty are present in the vast majority of these relationships" and "a per se approach saves the parties the trouble of expressing or negotiating their respective rights and eliminates difficult factual determinations in the event of litigation." Clarke, *The Fiduciary Obligations of Lenders in Leveraged Buyouts*, 54 MISS. L.J. 423, 427 (1984).

[98] Note, *The Fiduciary Controversy: Injection of Fiduciary Principles into the Bank-Depositor and Bank-Borrower Relationships*, 20 LOY. L.A.L. REV. 794, 798 (1987)(citing *World Vision Enter., Inc. v. American Broadcasting Co.*, 142 Cal. App. 3d 589, 594, 191 Cal. Rptr. 148, 151 (1983)).

[99] *See* Wilson v. Zorb, 15 Cal. App. 2d 526, 532, 59 P.2d 593, 596 (1936)("It takes something more than friendship or confidence in the professional skill and the integrity and truthfulness of another to establish a fiduciary relationship."); Franz v. Porter, 132 Cal. 49, 51, 64 P. 92, 94 (1901)(warm personal friendship not sufficient to establish fiduciary relationship).

[100] *See* Reid v. Key Bank of Southern Maine., Inc., 821 F.2d 9, 17 (1st Cir. 1987)(affirming dismissal of claim of breach of fiduciary duty); Horoco, Inc. v. American Nat'l Bank & Trust Co., 647 F. Supp. 1026, 1035 (N.D. Ill. 1986)(mere trust to perform contract insufficient).

[101] *See* Snow v. Merchants Nat'l Bank, 35 N.E.2d 213, 217 (Mass. 1941)(advice given in business relation does not create fiduciary relationship); Umbaugh Pole Bldg. Co. v. Scott, 58 Ohio St. 2d 282, 390 N.E.2d 320, 323 (1979)(absent demonstrations of trust relationship, lender does not have fiduciary duty to its borrower even if advice is offered).

[102] *See* Kaplan, *Fiduciary Responsibility in the Management of the Corporation*, 31 BUS. LAW 883, 886 (1976)(considers case law hopelessly confused); Wolenski & Econome, *Seduction in Wonderland, A Need for a Seller's Fiduciary Duty Toward Children*, 4 HASTINGS CONST. L.Q. 249, 265 (1977)(comments that courts have failed to articulate adequate fiduciary theories). For a discussion of the various theories upon which fiduciary obligations have been based, see Shepherd, *Towards a Unified Concept of Fiduciary*

The most commonly applied standards are the trust theory and the domination theory. Under the trust theory, a fiduciary relationship arises when one party justifiably reposes trust and confidence in the other and the other party knows or accepts the trust and confidence.[103]

Under the domination theory, a fiduciary relationship may arise if one party sufficiently dominates and controls the other.[104] The mere existence of unequal bargaining positions, however, is not sufficient domination to create a fiduciary relationship.[105]

Some courts, including Mississippi, intertwine the trust and domination concepts in determining whether a fiduciary relationship exists.[106] When dependency or control exists, it is more reasonable to assume that the parties intended to impose fiduciary restraints on the dominant party.[107] As will be discussed later, the issue of control is particularly crucial in cases in which third party creditors seek to impose liability upon lenders for corporate debts.[108]

Lenders are not fiduciaries per se.[109] The commercial inter-

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Relationships, 97 LAW Q. REV. 51, 53-71 (1981).

[103] *See* Committee on Children's Television v. General Foods Corp., 35 Cal. 3d 197, 673 P.2d 660, 675-76, 197 Cal. Rptr. 783, 798 (1983)(fiduciary must have knowingly undertaken to act, advise with the beneficiary's interest in mind); Kurth v. Van Horn, 380 N.W.2d 693, 695-96 (Iowa 1986)(A fiduciary " 'relationship exists when there is a reposing of faith, confidence and trust, and the placing of reliance by one upon the judgment and advice of the other.' "; quoting BLACK'S LAW DICTIONARY 563 (5th Ed. 1979)).

[104] *See infra* note 306 and accompanying text.

[105] *See, e.g.*, Carter Equip. Co. v. John Deere Industrial Equip. Co., 681 F.2d 386, 391 n.10 (5th Cir. 1982)("[W]ithout other contributing factors, inequality does not give rise to a fiduciary relationship.").

[106] *E.g., Carter Equip.*, 681 F.2d at 390-91 (fiduciary relationship arises under Mississippi law where parties share common interest in success of enterprise, trust is justifiably reposed, fiduciary dominates non-fiduciary); Klein v. First Edina Nat'l Bank, 293 Minn. 418, 196 N.W.2d 619, 623 (1972)(fiduciary relationship exists when one party places justifiable trust in another, other knows and accepts trust, trusting party's capacity to protect his own interests is diminished).

[107] *See Carter Equip*, 681 F.2d at 391 ("If the franchisor has power to control the franchisee, there is an increased likelihood that a fiduciary relationship exists, since trust or confidence necessarily must flow from the controlled or dominated party.").

[108] *See infra* notes 297-348 and accompanying text.

[109] *See, e.g.*, In re Letterman Bros. Energy Securities Litig., 799 F.2d 967, 976 (5th Cir.)(no general fiduciary relation between borrower, lender), *cert. denied*, 107 S.Ct. 1373 (1986); In re W.T. Grant Co., 699 F.2d 599, 609-10 (2d Cir. 1983)(no fiduciary duty in

ests of lenders and borrowers are different and usually adverse to one another.[110] The primary concern of each is its own interests, not the interests of the other.[111] Borrowers seek the lowest possible interest rate and the least restrictive payment and security terms. In contrast, lenders seek the highest possible return and as much security as the borrower can provide.[112] The conflicting interests of the lender and borrower are especially apparent in security agreements. Both lender and borrower recognize the object of the security agreement is to protect the lender by empowering it to act before the value of the lender's security is lost.[113]

Nevertheless, claims of fiduciary breach are frequently asserted against lenders. These claims usually fail because the borrower cannot show that he justifiably reposed trust in the lender[114] or that the lender knowingly accepted the trust reposed, elements required by the majority of courts.[115] Recently, however, courts in California[116] and Florida[117] have suggested

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collection of claim), *cert. denied*, 464 U.S. 822 (1983); Haroco, Inc. v. American Nat'l Bank & Trust Co., 647 F.Supp 1026, 1035 (N.D. Ill. 1986)(debtor-creditor relationship not fiduciary in character); Delta Diversified, Inc. v. Citizens & S. Nat'l Bank, 171 Ga. App. 625, 320 S.E.2d 767, 776 (1984)(no confidential relationship between bank, its borrowers); *Umbaugh Pole Bldg., Co. v. Scott*, 58 Ohio St. 2d 282, 286, 390 N.E.2d 320, 321 (1979)(relationship of debtor, creditor without more is not fiduciary relationship).

[110] *See* Weinberger v. Kendrick, 698 F.2d 61, 79 (2d Cir. 1982)(It "would be anomalous to require a lender to act as a fiduciary for interests on the opposite side of the negotiating table."), *cert. denied*, 464 U.S. 818 (1983); First Am. Nat'l Bank v. Mitchell, 359 So. 2d 1376, 1380 (Miss. 1978)(The relationship "was adverse so far as payment of the debt was concerned. . . .").

[111] *See* Note, *supra* note 98, at 799.

[112] *Id.* at 824.

[113] *See* Sneed & Athay, *supra* note 69, at 76 ("Since, the lender's primary goal is to obtain adequate security to cover its loan, it obtains contractual rights which will protect the value of the security and facilitate for closing on it.")

[114] *See, e.g.*, Denison State Bank v. Madeira, 230 Kan. 684, 640 P.2d 1242, 1245 (1982)(borrower could easily discover problem from its records); Stenberg v. Northwestern Nat'l Bank of Rochester, 307 Minn. 487, 238 N.W.2d 218, 219 (1976)(borrower was "capable of independent judgment").

[115] *See, e.g., Denison*, 640 P.2d at 1244 (one may not unilaterally impose fiduciary duties on another); Klein v. First Edina Nat'l Bank, 293 Minn. 418, 196 N.W.2d 619, 621-22 (1972)(There was "no evidence in the record to indicate that defendant ought to have known that plaintiff was placing her trust and confidence in defendant and was depending upon defendant to look out for her interests.")

[116] *See infra* notes 140, 149-151 and accompanying text.

[117] *See infra* notes 140-148 and accompanying text.

that lenders may have special disclosure obligations when they stand to benefit at a customer's expense, even if the traditional elements of a trust relationship are absent.

In the California case, *Barrett v. Bank of America*,[118] a bank allegedly reneged on an oral promise to release the personal guarantees of the Barretts when their corporation merged with another company. Shortly after the merger, the corporation filed bankruptcy and the bank assigned the guarantees to the Small Business Administration (SBA), which had insured the loan. The Barretts had to use the proceeds derived from selling their home to satisfy demands made by the SBA on the basis of the personal guarantees. They then sued the bank for, among other things, fraud.[119]

The trial court concluded that the Barretts were not entitled to recover for fraud because the jury found in favor of the bank on the element of scienter.[120] On appeal, the Barretts complained that the trial court should have given the jury an instruction on "constructive fraud", defined by the appellate court as being a breach of duties arising from a relationship of trust or confidence, without fraudulent intent.[121]

To apply the constructive fraud doctrine, the court had to find that a confidential relationship existed between the bank and the guarantors. Initially, the court noted confidential and fiduciary relationships are legally synonymous[122] and exist

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[118] 183 Cal. App. 3d 1362, 229 Cal. Rptr. 16 (1986).

[119] *Id.* at 17-18.

[120] *Id.* at 19. In response to special interrogatories, the jury concluded that the guarantors reasonably believed their guarantees would be released and that the lender's loan officer promised they would be released at or after consummation of the merger. The jury alsc found, however, that the loan officer's promise was warranted by the information known to him. Accordingly, the trial court concluded that the plaintiffs had not proven the scienter required to find fraud. *Id.*

[121] *Id.* at 20. The court explained:

> In its generic sense, constructive fraud comprises all acts, omissions and concealments involving a breach of legal or equitable duty, trust, or confidence, and resulting in damages to another. Constructive fraud exists in cases in which conduct, although not actually fraudulent, ought to be so treated — that is, in which such conduct is a constructive or quasi fraud, having all the legal effects of actual fraud. Constructive fraud usually arises from a breach of duty where a relation of trust and confidence exists.

Id.

[122] *Id.* One commentator, however, has noted the following distinction between the

"whenever trust and confidence is reposed by one person in another."[123] The court then observed that the relationship between a bank and its depositor is quasi-fiduciary in nature,[124] a conclusion the court erroneously suggested was supported by decisions from other jurisdictions.[125] Turning to the facts, the court reasoned that the requisite trust and confidence existed, at least to some degree, between the Barretts and the bank[126] since the Barretts testified that they had a close relationship with the

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relationships:

> The distinguishing feature between fiduciary and confidential relations seems to be that the confidential relation concept is a creation of a felt need for restitution where courts believe they cannot find a contract. Fiduciary cases, as with bargained for exchange cases, will protect the expectation interest; the confidential relation cases often seem only to protect the reliance or restitution interests.

Symons, *The Bank-Customer Relation: Part 1 - The Relevance of Contract Doctrine*, 100 BANKING L.J. 220, 235 (1983).

[123] *Barrett*, 229 Cal. Rptr. at 20.

[124] *Id.* The court relied upon its holding in Commercial Cotton Co. v. United Calif. Bank, 163 Cal. App. 3d 511, 209 Cal. Rptr. 551, 554 (1985), discussed *infra* notes 128-132 and accompanying text.

[125] "Other jurisdictions recognize a similar relationship of trust and confidence exists between a bank and its loan customers which gives rise to a duty of disclosure of facts which may place the bank or a third party at an advantage with respect to the customer." *Barrett*, 229 Cal. Rptr. at 20, *citing* Klein v. First Edina Nat'l Bank, 293 Minn. 418, 196 N.W.2d 619 (1972), First Nat'l Bank v. Brown, 181 N.W.2d 178 (Iowa 1970), and Stewart v. Phoenix Nat'l Bank, 49 Ariz. 34, 64 P.2d 101 (1937). The *Klein* court held that a lender had no fiduciary duty to disclose to a person providing security for a new note that the borrower had an earlier loan and that the collateral being provided would secure both notes. Even though the plaintiff testified she was a long-time customer and trusted the bank like she would her doctor or lawyer, the court concluded no fiduciary relationship existed because there was no evidence the bank knew or should have known the plaintiff expected the bank to protect her interest. *Klein*, 64 P.2d at 623. Since no such evidence was introduced in *Barrett* either, its reliance on *Klein* is anomalous. The *Brown* and *Stewart* decisions provide thin support for the *Barrett* holding. In *Brown*, the court held that a party in a position of trust, with superior knowledge of the facts, must disclose all material facts he is aware of. However, the court based its holding on a theory of fraud, not breach of fiduciary duty. *Brown*, 181 N.W.2d at 184. *Stewart* also involved a claim of actual fraud. In holding for the plaintiff, the court held that the relation between the plaintiff and the bank "was far beyond that of a mere debtor and creditor and that because of changes in the banking industry the plaintiff had to rely upon the bank to give advice in good faith." *Stewart*, 64 P.2d at 106. The *Stewart* court did not use the word fiduciary; however, the dealings between the parties recited by the court suggest that the mutuality required in *Klein* — trust and knowledge of the trust — was present. *Id.* at 104-06.

[126] *Barrett*, 229 Cal. Rptr. at 20-21.

bank, had relied upon the bank's advice and had shared confidential information with the bank.[127] Interestingly, no evidence was presented to demonstrate that the bank knew of or accepted the Barrett's trust.

The court relied on its earlier decision in *Commercial Cotton Co. v. United California Bank*[128] in concluding that the bank-depositor relationship was at least quasi-fiduciary. The issue in *Commercial Cotton* was whether a depositor could recover in tort as well as in contract for breach of the covenant of good faith and fair dealing.[129] The bank argued that under California law, a "special relationship" must exist before a tort action would arise. The court agreed[130] but found that a "special relationship" existed because the bank-depositor relationship involved elements of "public interest, adhesion, and fiduciary responsibility."[131] The court compared the banking industry to the insurance industry, noting both were highly regulated and both performed a vital public service. Since insurance companies were liable in tort for breach of the implied covenant of good faith and fair dealing, the court concluded that banks should be also.[132]

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[127] *Id.*

[128] 163 Cal. App. 3d 511, 209 Cal. Rptr. 551 (1985).

[129] The case arose from the wrongful payment of a check. The depositor had notified the bank of missing checks. Several years later one of the missing checks, bearing an unauthorized signature, was negotiated. Eighteen months later, the depositor demanded his account be recredited. The bank refused, arguing the statute of limitations had run. In a previous case involving the same bank, the California Supreme Court had held that the statute of limitations in question was inapplicable to negligence claims. Accordingly, the plaintiff contended the bank had acted in bad faith since it refused to recredit the funds despite the bank's actual knowledge of the court's prior ruling. *Commercial Cotton*, 209 Cal. Rptr. at 554.

[130] The court relied on Seamen's Direct Buying Serv., Inc. v. Standard Oil Co., 36 Cal. 3d 752, 686 P.2d 1158, 206 Cal. Rptr. 354 (1984), in which the California Supreme Court held that a claim for tortious breach of the covenant of good faith and fair dealing can be asserted if the breach arises in connection with a special relationship like that of insured-insurer or when a party denies, in bad faith, the existence of a contract or raises similar spurious defenses to liability. *Id.* at 1167, 206 Cal. Rptr. at 363. The *Commercial Cotton* court held that the bank's statute of limitation defense was similarly spurious. *Commercial Cotton*, 209 Cal. Rptr. at 554.

[131] *Commercial Cotton*, 209 Cal. Rptr. at 554.

[132] *Id.* California imposes tort liability upon insurers for breach of the covenant of good faith and fair dealing. *See* Fletcher v. Western Nat'l Life Ins. Co., 10 Cal. App. 3d 376, 89 Cal. Rptr. 78, 93 (1970)(disability insurance policy). For a discussion of the impo-

The *Commercial Cotton* and *Barrett* decisions are the first to suggest that the relationship between a bank and its depositors is "quasi-fiduciary."[133] Other jurisdictions generally agree that the bank-depositor relationship, like the bank-borrower relationship, is a debtor-creditor relationship in which each party is responsible for his own interests.[134]

The Florida Supreme Court imposed fiduciary obligations on a lender in *Barnett Bank v. Hooper*.[135] In *Barnett Bank*, the bank owed conflicting duties to two customers. Hooper, a long time bank customer, borrowed money from the bank which he deposited in the account of Mr. Hosner, also a bank customer. At the time this loan was made, the bank suspected Hosner of being involved in a check-kiting scheme. Because of Hooper's deposit, the bank was able to zero-out Hosner's account when the check-kiting scheme was later confirmed.[136]

Hooper sued for rescission of his loans, contending the bank had breached a fiduciary duty in failing to disclose its suspicions.[137] Utilizing the trust theory, the court concluded that the bank-borrower relationship required a bank to disclose material facts known only to the bank if the bank could possibly benefit

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sition of tort liability for breach of the duty of good faith, see *supra* note 26.

[133] *See* Note, *supra* note 98, at 814 (*Commercial Cotton* "unparalleled and unsupported").

Authors' note: A claim of constructive fraud premised on the existence of a fiduciary relationship between borrowers and their bank lender was rejected by a California appellate court in Kruse v. Bank of America, to be reported in 201 Cal. App. 3d 354, 248 Cal. Rptr. 217 (1988), which was decided after this article was submitted to the printer. The court refused to navigate what it described as the "murky waters" of *Commercial Cotton*. Instead, the court relied on the failure of the borrowers and guarantors to prove justifiable reliance on statements made by the bank officer to overturn a 146 million dollar verdict.

[134] *See, e.g.*, Bank of Marin v. England, 385 U.S. 99, 101 (1966)(The "relationship of bank and depositor is that of debtor and creditor founded upon contract."); Manson State Bank v. Tripp, 248 N.W.2d 105, 108 (Iowa 1976)(no confidential relationship); Dugan v. First Nat'l Bank, 227 Kan. 2d, 606 P.2d 1009, 1014 (1980)(relationship of debtor-creditor not fiduciary); Klein v. First Edina Nat'l Bank, 293 Minn. 418, 422, 196 N.W.2d 619, 622 (1972)(bank-borrower relationship is not confidential relationship); Deposit Guar. Bank & Trust Co. v. Merchants Bank & Trust Co., 171 Miss. 553, 558, 158 So. 136, 137-38 (1934)(deposit not trust fund).

[135] 498 So. 2d 923 (Fla. 1986).

[136] *Id.* at 924.

[137] *Id.* at 924.

at the expense of the borrower.[138]

A persuasive dissent pointed out that the evidence did not show that the borrower had justifiably relied on the bank or that the bank had accepted such reliance.[139]

The most frequently cited case in support of the majority approach requiring proof of these elements is the Minnesota Supreme Court's decision in *Klein v. First Edina National Bank*.[140] Klein, a long time bank customer, pledged stock to secure a loan to her employer. When this pledge was made, Klein was not aware that the employer owed money on an earlier loan and that the bank wanted Klein's stock as security for both loans. When the bank foreclosed on the stock, Klein sued, alleging that the bank's failure to disclose the earlier loan constituted fraud.[141] In considering this claim, the court acknowledged that a lender ordinarily is not a fiduciary of its borrower and thus has no special disclosure obligations. The court concluded, however, that a special relationship requiring disclosure may arise when "the bank knows or has reason to know that the customer is placing his trust and confidence in the bank and is relying on the bank so to counsel and inform him."[142] Klein testified she had been a customer of the bank for twenty years and that she trusted the bank's representative; but no evidence was introduced to demonstrate the lender knew or should have known of this trust. Accordingly, the court held no fiduciary relationship existed.[143]

In *Denison State Bank v. Madeira*,[144] the court rejected a borrower's claim that the bank breached its fiduciary obligation

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[138] *Id.* at 925. The bank contended it would have breached the duty of confidentiality it owed Hosner if it had disclosed its suspicions. The court created a "special circumstances" exception to the duty of confidentiality permitting disclosure where the bank, having actual knowledge of a fraud, enters into a transaction with a customer in furtherance of the fraud or when the bank has a fiduciary relationship with the customer to whom the disclosure is made. The other exceptions enumerated include compulsion of law, public interest, bank's interest, express or implied consent. *Id.*

[139] *Id.* at 926 (Boyd, J., dissenting); *see also supra* notes 142, 154 and accompanying text.

[140] 293 Minn. 418, 196 N.W.2d 619 (1972).

[141] *Id.* at 621.

[142] *Id.* at 623.

[143] *Id.*

[144] 230 Kan. 684, 640 P.2d 1235 (1982).

by failing to disclose the financial problems of another bank customer's automobile dealership. Madeira invested in the dealership and entered into a loan agreement with the bank.[145] The bank failed to disclose all of the facts in its possession about the dealership's financial condition, including the fact that certain assets had been pledged to another creditor.[146] The court concluded that the imposition of a fiduciary duty on the bank was inappropriate because Madeira was capable of discovering the dealership's financial problems from the dealership's records[147] and because the bank had not consciously assumed the fiduciary duties Madeira sought to impose on it.[148]

Failure to demonstrate justifiable reliance contributed to the reversal of the multimillion dollar damage award in *Centerre Bank*.[149] The court rejected the Browns' claim that the bank breached a fiduciary duty by failing to disclose that Distributors, Inc.'s debt had been classified as a problem loan.[150] The evidence established that one of the Brown family members managed Distributors, Inc., that the Browns all knew of Distributors, Inc.'s financial difficulties, and that the financial information the bank had relied upon in classifying the loan was readily available to the Browns. Accordingly, the court held that the Browns had no right to depend upon the bank to disclose information about the classification of Distributors, Inc.'s loan.[151]

Mississippi courts have held that a fiduciary relationship may arise in commercial transactions when the circumstances establish that (i) the parties have "shared goals" in each other's commercial activity, (ii) one party justifiably places trust or confidence in the integrity and fidelity of the other, and (iii) the

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[145] *Id.* at 1239.

[146] *Id.* at 1243.

[147] *Id.* at 1245.

[148] *Id.* at 1244. The court observed that a lender ordinarily does not owe a fiduciary obligation to its borrower, noting: "[O]ne may not abandon all caution and responsibility for his own protection and unilaterally impose a fiduciary relationship on another without a conscious assumption of such duties by the one sought to be held liable as a fiduciary." *Id.* at 1243-44.

[149] 705 S.W.2d 42 (Mo. Ct. App. 1985). See *supra* notes 60-64 and accompanying text for a discussion of the facts in *Centerre Bank*.

[150] *Centerre Bank*, 705 S.W.2d at 52.

[151] *Id.* at 52-53.

trusted party has effective control over the other party.[152] When these criteria are satisfied, a duty of "good faith and fair dealing" arises which bars the fiduciary from using its power to destroy, injure or gain a preferential advantage over the weaker party or to frustrate the weaker party's legitimate commercial expectations.[153] Even this duty, however, yields to the express rights granted to the fiduciary in the parties' contract, provided the contractual terms are not illegal or unconscionable.[154]

The lender-borrower relationship does not fit the criteria outlined above. The lender and borrower are not involved in the same business activity; their interests are fundamentally different. As noted earlier, neither has a justifiable basis for concluding that the other is watching out for its interests; the relationship is arms-length.[155] Most importantly, the lenders' apparently superior bargaining position does not deprive the borrower of his capacity to act independently; the borrower remains free to take his business elsewhere.[156]

The Mississippi Supreme Court has recently made apparently conflicting statements about the lender-borrower relationship. In a 1986 case, *West Point Corp. v. New North Mississippi Federal Savings & Loan Association*,[157] the court cited with approval a New Mexico decision, which held that a lender does not

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[152] Carter Equip. Co. v. John Deere Indus. Equip., 681 F.2d 386, 390-91 (5th Cir. 1982). For a discussion of the *Carter Equip.* decision, see Keker & Hunt, *supra* note 94, at 38-42.

[153] *Carter Equip.*, 681 F.2d at 392.

[154] See *supra* notes 84-88 and accompanying text.

[155] See *supra* notes 109-115 and accompanying text.

[156] Domination and dependency are essential to a finding of a fiduciary relationship. In determining control, one key is whether the less powerful party retained its freedom to protect its interest by contracting with others. *See* Jackson Rapid Delivery Serv., Inc. v. Jones Truck Lines, Inc., 641 F. Supp. 81, 84 (S.D. Miss. 1986)(no fiduciary relationship where free to contract with others); *see also Carter Equip.* 681 F.2d at 391 (power to control is crucial issue.); In re Will of Polk, 497 So. 2d 815, 818 (Miss. 1986)("[I]t is the dominant, over mastering influence over the dependent party, justifiably reposed, that gives rise to a presumption of undue influence."); In re Will and Estate of Varvaris, 477 So. 2d 273, 278 (Miss. 1985)(Dependency is a "crucial question.").

[157] 506 So. 2d 241 (Miss. 1986). In *West Point Corp.*, the court held that MISS. CODE ANN. § 75-3-606, which deals with impairment of collateral under the U.C.C., does not impose a duty upon a mortgagee to preserve real estate collateral that is not in the mortgagee's possession. *West Point Corp.*, 506 So. 2d at 244-45. The court emphasized the commercial impracticality of imposing such a requirement on the lender. *Id.* at 244.

owe a fiduciary obligation to its borrowers.[158] In several earlier opinions, however, the Mississippi Supreme Court opined that a trust relationship exists between a mortgagor and mortgagee.[159] The most important of these decisions is *First American National Bank v. Mitchell.*[160] In *Mitchell*, a bank officer induced the Mitchells to sell their property to a friend by wrongfully threatening to foreclose on the property.[161] The officer knew his friend had arranged to resell the property to a second buyer for a higher price. The officer did not disclose the availability of a second buyer to the Mitchells.[162] The court concluded that the officer had a duty to do so, reasoning in part that his failure to disclose the offer was an abuse of the trust relationship between mortgagor and mortgagee.[163]

The court cited other reasons for its decision, specifically the officer's fraudulent conduct[164] and his failure to disclose facts peculiarly within his knowledge.[165] These facts were sufficient to impose liability on the lender without reference to fiduciary concepts, and the case is distinguishable on that basis.[166]

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[158] *West Point Corp.*, 506 So. 2d at 244, *citing* American Bank of Commerce v. Covolo, 88 N.M. 405, 540 P.2d 1294 (1975). In *Covolo*, the guarantors' guaranty agreements waived their right to contest the lender's release of the collateral securing a loan. *Covolo*, 540 P.2d at 1296-97. The lender effectively released the collateral by failing to perfect its security interest before the borrower filed bankruptcy. *Id.* at 1296. The guarantors argued that since the lender was a fiduciary it could release the collateral only in a commercially reasonable manner. *Id.* at 1297. In rejecting the guarantors' argument, the court remarked: "No authority is cited to support the remarkable proposition that a bank owes fiduciary duties to its debtors and obligors. Notwithstanding the growth of consumerism, this nirvana is yet to be reached." *Id.* at 1296.

[159] This principle was initially articulated by the court in two 1940 decisions, Federal Land Bank v. Collum, 201 Miss, 266, 276, 28 So. 2d 126, 127 (1946) and Meyers v. American Oil Co., 192 Miss. 180, 187, 5 So. 2d 218, 220 (1941). In *Federal Land Bank*, the court stated "[T]he relationship between mortgagor and mortgagee is one of trust and is such that neither shall so conduct himself in regard to the mortgage or the mortgaged property as to prejudice the substantial rights of the other."
Federal Land Bank, 201 Miss. at 276, 28 So. 2d at 127.

[160] 359 So. 2d 1376 (Miss. 1978).

[161] *Id.* at 1377-78.

[162] *Id.* at 1378.

[163] *Id.* at 1380.

[164] *Id.* at 1378-79.

[165] *Id.* at 1380.

[166] *Id.* The court also noted that the party's relationship was adverse "so far as payment of the debt was concerned." In American Nat'l Ins. Co. v. Murray, 383 F.2d 81 (5th

Since lenders are liable under Mississippi law for negligent omissions,[167] there is no sound reason for imposing additional disclosure obligations on mortgagees.[168] Fiduciary obligations should be imposed only in those rare cases in which a lender so dominates the will of its customer that a confidential relationship must be presumed to exist.[169] The proper approach is demonstrated by the Mississippi Supreme Court's decision in *White v. Hancock Bank*.[170]

In *White*, White sold his business to two purchasers; the purchasers paid White with a certified check drawn on a West

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Cir. 1967), a case applying Mississippi law, the court refused to recognize a fiduciary obligation between a mortgagor and mortgagee after payment of the mortgage, but held:

> Where the parties deal at arms-length, there is no duty of disclosure where the facts are equally within the knowledge of both parties; but if the facts are peculiarly within the knowledge of one party, there may be a duty of disclosure under particular circumstances.

Id. at 87. Relying on this rule, the court reversed the trial court's grant of summary judgment to the mortgagor. *Id.* at 87-88. The court declined to specify when a special duty of disclosure might arise. A comment to the Restatement (Second) of Torts notes:

> There are situations in which the defendant not only knows that his bargaining adversary is acting under a mistake basic to the transaction, but also knows that the adversary by reason of the relation between them, the customs of the trade or other objective circumstance, is reasonably relying upon a disclosure of the unrevealed fact if it exists.

RESTATEMENT (SECOND) OF TORTS § 551 comment l (1977). *See* Citizens State Bank v. Federal Deposit Ins. Corp., 639 F. Supp. 758, 763 (S.D. Okla. 1986)(finding duty to disclose even without fiduciary relationship); *see also infra* notes 400-407 and accompanying text. *But see* Shell Oil Co. v. Mills Oil Co., Inc., 717 F.2d 208, 214 (5th Cir. 1985)(guarantor had access to financial information allegedly concealed by lender; therefore, no duty to disclose existed).

[167] Mississippi has recognized that lenders may be liable to their customers for negligent misrepresentations or omissions in connection with loan or deposit transactions. Because this theory first arose in cases involving inaccurate credit references, it is discussed in the section dealing with lender liability to third parties. *See infra* notes 408-429 and accompanying text.

For a discussion of potential lender liability for negligence in special contexts, see generally Ellis & Gray, *supra* note 26 (discussing negligent processing of loan applications) and Malloy, *Lender Liability for Negligent Real Estate Appraisals*, 1984 U. ILL. L. REV. 53 (1984).

[168] With respect to the Mississippi decisions suggesting a trust relationship between mortgagor and mortgagee, C.J.S. notes: "While it has been stated broadly that the relationship between mortgagor and mortgagee is one of trust, technically it is not of a fiduciary character and contracts between the two are regarded and treated as any other contract would be." 59 C.J.S. *Mortgages* § 294, at 367 (1949).

[169] See *supra* note 156.

[170] 477 So. 2d 265 (Miss. 1985).

Indies Bank.[171] The bank immediately credited White's account for the amount of the check[172] and loaned White the money he needed to pay a debt he owed.[173] Subsequently, the check was dishonored by the foreign bank.[174]

White sued the bank alleging breach of fiduciary duty and negligence.[175] In rejecting White's claims, the court observed there was no evidence that the bank agreed to represent White or to look out for his interests. Accordingly, the court concluded the bank officer's casual remark about the check did not make the officer and the bank "financial good samaritans" who assumed an obligation to verify the check before White accepted it from the purchasers.[176]

C. The Farah Torts — Fraud, Duress and Interference

The phrase "Farah Torts" is convenient shorthand for the theories of fraud, duress and interference, all of which a borrower successfully asserted in *State National Bank v. Farah Manufacturing Co.*[177] *Farah*, a Texas appellate court case, has become a landmark decision in the area of lender liability.

The key actors in *Farah* were three bank lenders, Farah Manufacturing Co. (FMC) and William F. Farah (Farah). Mr. Farah was the controlling shareholder of FMC and its former chief executive officer (CEO). After FMC experienced several years of financial losses,[178] the FMC board of directors forced Farah to resign as CEO. When FMC's losses continued, Farah asked the board to re-elect him CEO and to elect two new directors.[179] However, a management change clause in FMC's loan agreement permitted the declaration of a default "for any reason" if any two of the lenders deemed that a change in the CEO

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[171] *Id.* at 267.

[172] *Id.* at 268.

[173] *Id.* at 267-68.

[174] *Id.* at 268. Some discussion as to the validity of the check apparently had taken place between White and a bank officer. *Id.* at 267. According to the evidence, the officer volunteered that the check "looked all right to him." *Id.*

[175] *Id.*

[176] *Id.* at 271.

[177] 678 S.W.2d 661 (Tex. Ct. App. 1984).

[178] *Id.* at 667, 670.

[179] *Id.* at 670.

position adversely affected their interest.[180]

The FMC board requested that the lenders approve Farah's return.[181] Upon considering this request, the lenders decided either not to declare a default or in fact remained undecided as to the appropriate action to be taken.[182] Neither of these positions was disclosed to FMC.[183] Instead, the lenders acted to prevent Farah's election by falsely representing they had decided to declare a default if Farah was elected. Their attorney wrote the FMC board that Farah's election was unacceptable and that the lenders would not grant FMC a waiver of default;[184] their attorney also told Farah and another director that the lenders would bankrupt and padlock FMC if Farah became CEO.[185]

Due to these threats, Farah abandoned his efforts to elect new board members and to become CEO.[186] The CEO post and two of three new board positions were filled by persons affiliated with the lenders.[187] When FMC's finances continued to degenerate, the board retained a management consultant, recommended by the lenders, who eventually became CEO.[188] While CEO, this consultant sold some of FMC's assets to its competitors in order to make early loan payments to the lenders.[189]

Thereafter, Farah initiated a proxy fight to regain control of

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[180] *Id.* at 667. The clause allowed a declaration of default for "[a]ny change in the office of President and Chief Executive Officer of Farah [Manufacturing Company, Inc.] or any other change in the executive management of Farah [Manufacturing Company, Inc.] which any two banks shall consider for any reason whatsoever, to be adverse to the interests of the Banks." *Id.* After Farah was forced to resign, this clause was substituted for weaker clauses in two earlier loan agreements. *Id.* at 670.

[181] *Id.*

[182] *Id.* at 680. The lenders held a series of meetings. There was conflicting evidence about what the lenders decided to do. *Id.* at 670-73.

[183] *Id.* at 680.

[184] *Id.* at 672.

[185] *Id.* at 673-74.

[186] *Id.* at 674-75. The court noted the evidence indicated Farah's board nominees were not elected due to the lender's objection; no provision of the loan agreement pertained to changes in the board. *Id.* at 675.

[187] *Id.* at 676. The new C.E.O. was a director of one of the banks. *Id.* at 670. One of the new directors was a former employee of one of the lenders; additionally, the lender promised to indemnify the director from any liability arising out of his board service. *Id.* at 676. Another new director also served on one of the lender's boards. *Id.*

[188] *Id.* at 677.

[189] *Id.* at 678.

FMC.[190] Not surprisingly, the lenders financed a lawsuit to block Farah's return.[191] However, when Farah prevailed in the proxy battle, the lenders decided not to declare a default if FMC would agree to restructure the loan.[192] In due course, Farah restored FMC's economic health.[193] Upon repayment of the loan, FMC sued the lenders for fraud, duress and tortious interference with its management.[194] A modified verdict for over 18.6 million dollars was affirmed by the appellate court.[195]

The preceding facts set the stage for an analysis of the *Farah* Torts.

1. Fraud

Fraud occurs when a speaker knowingly or recklessly makes a false representation for the purpose of inducing the listener to act or refrain from acting in reliance upon the representation.[196] Ordinarily, the representation must be an unequivocal statement of past or present fact.[197] However, the key is the speaker's intentions, not the form of the statement. Accordingly, a representation capable of two interpretations, one false and one true, is fraudulent if made with the intention that the listener accept the false rendition.[198] Similarly, a representation of future inten-

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[190] *Id.* at 679.

[191] *Id.* More specifically, the lenders financed a suit to remove Farah as the trustee of a trust controlling a significant block of FMC shares. *Id.*

[192] *Id.* at 680.

[193] *Id.*

[194] *Id.* at 667.

[195] *Id.* at 699.

[196] RESTATEMENT (SECOND) OF TORTS § 525 (1977). In McMahon v. McMahon, 247 Miss. 822, 157 So. 2d 494 (1963), the Mississippi Supreme Court outlined the elements of proof required to establish fraud:

> To establish fraud, there must be a representation of the falsity thereof, the materiality of the false representations, the speaker's intent that it be acted on by the other in the anticipated manner, the hearers ignorance of its falsity, his reliance on its truth, his right to rely thereon, and his consequent and proximate injury.

McMahon, 247 Miss. at 836, 157 So. 2d at 501; *accord*, Grenada Ready-Mix Concrete, Inc. v. Watkins, 453 F. Supp. 1298, 1309 (N.D. Miss. 1978)(citing same factors).

[197] *See* Gardner v. Jones, 464 So. 2d 1144, 1149 (Miss. 1985)(representations were vague); McArthur v. Fillingame, 184 Miss. 869, 876, 186 So. 828, 829 (Miss. 1939)(ordinarily representation "must relate to past or presently existing facts").

[198] RESTATEMENT (SECOND) OF TORTS § 527 (1977) states:

tion, such as a promise, is fraudulent if the intention is purposefully misstated.[199]

These rules were applied by the court in *Farah*.[200] The lenders argued that fraud cannot arise from a warning of an intention to enforce legal rights.[201] The court disagreed, reasoning that the lenders' letter of warning and their statements about bankrupting and padlocking FMC were fraudulent because they created "a false impression regarding the lenders' decision (or lack of decision) to declare a default."[202]

Borrowers have successfully asserted claims of promissory fraud against lenders in other cases as well. In *Sterling v. Chemical Bank*,[203] the court held that a group of guarantors stated a claim for fraud where they alleged they were induced to resign from their corporate positions by fraudulent assurances that the corporation's outstanding loans would not be called.[204] In *Sanchez Corea v. Bank of America*,[205] the court upheld a verdict for fraud against a lender who falsely promised to advance further financing if additional security for a line of credit was provided by the borrower.[206] In *Crystal Springs Trout Co. v. First State Bank*,[207] the court upheld a fraud verdict because the

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> A representation that the maker knows to be capable of two interpretations, one of which he knows to be false and the other true is fraudulent if it is made: (a) with the intention that it be understood in the sense in which it is false, or (b) without any belief or expectation as to how it would be understood, or (c) with reckless indifference as to how it would be understood.

Id.

[199] *See, e.g.*, Phillips v. Chevron U.S.A., Inc., 792 F.2d 521, 526 (5th Cir. 1986)(making promise with no intention of performing constitutes fraud); Walker v. U-Haul Co., 730 F.2d 1068, 1070 (5th Cir. 1984)(same); *see also infra* notes 387-409 and accompanying text. *But see* In re Posey, 57 Bankr. 858 (Bankr. N.D. Miss. 1985)(no fraud by lender because alleged misrepresentation promissory in nature).

[200] *Farah Mfg. Co.*, 678 S.W.2d at 680-82 (citing RESTATEMENT (SECOND) OF TORTS § 527 (1977) and other authorities).

[201] *Id.* at 681.

[202] *Id.* at 682.

[203] 382 F. Supp. 1146 (S.D. N.Y. 1974), *aff'd*, 516 F.2d 1396 (2d Cir. 1975)(*overruled on other grounds*, Campos v. Lefevre, 825 F.2d 671 (2d Cir. 1987).

[204] *Id.* at 1153.

[205] 38 Cal. 3d 892, 701 P.2d 826, 215 Cal. Rptr. 679 (1985).

[206] *Id.*, 701 P.2d at 830, 839, 215 Cal. Rptr. at 683, 692.

[207] 732 P.2d 819 (Mont. 1987), *aff'd in part, rev'd in part on rehearing*, 736 P.2d 95 (Mont. 1987).

lender falsely represented that it could secure another lender's participation in a loan package which otherwise would have exceeded the lender's lending limit.[208]

Borrowers are not always successful, however. For instance, a finding of promissory fraud was overturned in *Centerre Bank*.[209] The court concluded that the Browns had not reasonably relied upon the loan officer's representations that the corporate loan would be extended, since they knew the loan officer lacked the authority to make them.[210]

Mississippi borrowers have successfully pursued fraud claims against lenders. Some of the leading cases involve a lender's failure to disclose material information to its borrower.[211] Mississippi also recognizes that fraud can arise from a false promise or statement of intention.[212] For instance, in *Home Security Corp. v. Gentry*,[213] the court held that a lender had fraudulently induced a borrower to execute an incomplete mortgage by promising to insert a description of only one of thirty-five acres owned by the borrower. The circumstances indicated that the lender made its promise with no intention of complying. Accordingly, the court found that fraud had been committed by the lender's insertion of a description covering the entire acreage.[214]

No Mississippi decision directly addresses the type of fraudulent conduct alleged in *Farah*. On the reported facts, it is difficult to quarrel with the court's finding of fraud. The precedential value of *Farah* should not be overstated, however. The lenders' threats were a bluff. Bluffs are frequently made in com-

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[208] *Id.* at 826. At the time the representation was made, the lender had not even asked the second lender if it wanted to participate in the loan. *Id.*

[209] *See Centerre Bank*, 705 S.W.2d at 64 (discussion of the *Centerre Bank* facts).

[210] *Id.* at 50.

[211] *See supra* notes 161-166 and accompanying text (discussion of cases dealing with lender's failure to disclose material information).

[212] *E.g.*, Phillips v. Chevron U.S.A., Inc., 792 F.2d 521, 526 (5th Cir. 1986)(making promise with intention not to perform is fraudulent under Mississippi law); Walker v. U-Haul Co. of Miss., 730 F.2d 1068, 1070 (5th Cir. 1984)(same); McArthur v. Fillingame, 184 Miss. 869, 876, 186 So. 828, 829 (1939)(same).

[213] 235 So. 2d 249 (Miss. 1970).

[214] *Id.* at 251. *But see* Ricks v. Bank of Dixie, 352 So. 2d 798, 801 (1977)(where no showing of inability to read note, claim alleging plaintiff had been tricked into signing not allowed).

mercial and legal negotiations. No fraud occurs because all the participants know or should know that declarations of position are not necessarily final. In *Farah*, the lenders deliberately misstated their position and intentions under circumstances in which FMC was fully justified in accepting the lenders' statements at face value. Absent those special circumstances, a different verdict might have been appropriate.

2. Duress

Duress and undue influence are parallel but distinct concepts.[215] Both theories are based upon the principle that a contract procured by unconscionable means should not be enforced.[216] Neither theory ordinarily is applicable unless the circumstances establish that the free agency of the complaining party was wrongfully destroyed.[217] Duress applies when the wrongdoer acts by force or threats; undue influence applies when the wrongdoer abuses the confidence of his victim.[218]

Duress can take two forms — physical compulsion[219] or business compulsion.[220] Business compulsion occurs when consent is obtained by improper threats that leave the threatened party with no reasonable alternative but to give in.[221] Therefore, to establish duress, the proof must show imminent financial distress plus the absence of practical alternatives.[222]

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[215] D. DOBBS, REMEDIES, at 672 (1973).

[216] *Id.* at 656, 672-73; *see* First Nat'l Bank v. Caruthers, 443 So. 2d 861, 864 n.3 (Miss. 1983)(contracts obtained by overreaching, duress, undue influence are unenforceable).

[217] *Compare* Duckworth v. Allis Chalmers Mfg. Co., 247 Miss. 198, 203, 150 So. 2d 163, 165 (1963)(The duress "of the dominant party must have been such as to override the volition of the victim.") *with* Sanders v. Sanders, 126 Miss. 610, 627, 89 So. 261, 264 (1921)(influence must overcome will of testator to be undue).

[218] "In fraud cases, the wrongdoer works his will with his victim by deception, and ordinarily this requires a misrepresentation of fact. In duress cases, he works his will by obtaining the confidence and trust of his victim." DOBBS, *supra* note 215, at 674.

[219] RESTATEMENT (SECOND) OF CONTRACTS § 174 (1981). *See, e.g.*, Johnson v. Glass, 156 Miss 670, 671-72, 126 So. 476, 477 (1930)(plaintiff had been whipped, thrown into jail).

[220] RESTATEMENT (SECOND) OF CONTRACTS § 175 (1981).

[221] *Id.*

[222] Palmer Barge Line v. Southern Petroleum Trading, 776 F.2d 502, 506 (5th Cir. 1985). *See also* Grubel v. Union Mutual Life Ins. Co., 54 A.D. 2d 686, 387 N.Y.S. 2d 442,

No concrete standard has been formulated for determining what constitutes an improper threat or an absence of reasonable alternatives. A threat must be unlawful to be improper. Merely threatening to do that which one has a legal right to do ordinarily is not sufficient to establish duress.[223] The application of financial pressure, without more, is not duress, even if the pressure is created by a disparity in bargaining power. Likewise, since effective redress is available through the courts, economic discomfort or strain is insufficient to establish lack of a reasonable alternative.

In *Farah*, the same facts[224] which contributed to a finding of fraud resulted in a finding of duress as well. The lenders argued that duress cannot arise from warnings about the consequences of enforcing legal rights.[225] The court acknowledged that the management change clause authorized the lenders to declare a default and accelerate the loan if FMC changed its CEO.[226] The court concluded, however, that section 1-208 of the U.C.C. precluded evoking the management change clause unless the lenders concluded in good faith that their security was impaired. Until Farah was actually elected, the lenders had no basis to

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443 (1976)(financial pressure insufficient even with unequal bargaining power); DOBBS, *supra* note 215, at 659 ("Much coercion - strong bargaining power - is permissible, expected and heartily approved in a competitive economic society.")

[223] *See* Peterson v. Merchants Truck Line, Inc., 448 So. 2d 288, 290-91 (Miss. 1984)(threat to turn matter over to fidelity insurance carrier not wrongful since individual had legal right to do so); *McGehee v. McGehee*, 227 Miss. 170, 183, 85 So. 2d 799, 804 (Miss. 1956)(no duress where acting within legal rights).

According to the Restatement (Second) of Contracts, a threat is improper if:

(a) what is threatened is a crime or a tort, or the threat itself would be a crime or a tort if it resulted in obtaining property,

(b) what is threatened is a criminal prosecution,

(c) what is threatened is the use of civil process and the threat is made in bad faith, or

(d) the threat is a breach of the duty of good faith and fair dealing under a contract with the recipient.

RESTATEMENT (SECOND) OF CONTRACTS § 176(1)(1981).

[224] *Farah Mfg.*, 678 S.W.2d at 683. Specifically, the court considered the lenders' letter to the FMC board, its oral threats to bankrupt and padlock FMC, and the lenders' interference with the election of FMC's board. *Id.*

[225] *Id.* at 684.

[226] *Id.* at 686.

conclude that their prospects of payment were impaired.[227] Accordingly, the court held that the lenders' threats were improper and thus constituted duress.[228]

The court erred. As previously discussed, section 1-208 of the U.C.C. places a good faith limitation only on a lender's right to accelerate a loan "at will" or for "insecurity." It was not intended to limit the ability of lenders and borrowers to define a particular event — such as a change in management — as an event of default which would permit acceleration.[229] Absent fraud, the lenders were entitled to warn FMC of the potential consequences of Farah's election as CEO. Any other rule would impose unwarranted restrictions upon both borrowers and lenders by inhibiting lenders' freedom to respond to borrowers' requests for approval of contemplated conduct.

Mississippi courts have consistently rejected claims of duress based upon lenders' threats to enforce their rights under loan agreements. For instance, in *River Valley Co. v. Deposit Guaranty National Bank*,[230] the court rejected River Valley Co.'s claim that a mortgage had been procured by duress.[231] When the mortgage was granted, River Valley was in default under a line of credit agreement. The lender threatened to file suit unless River Valley provided the lender with additional security and a note for the sums owed. Thereafter, when River Valley failed to pay the note, the lender foreclosed.[232] The court concluded that the lenders' threats were not duress because the lender "had a perfect legal right to pursue all legal remedies at its command to collect the debt"[233] and because there was no

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[227] *Id.* at 685. The court relied on Brown v. Avemco Inv. Corp., 603 F.2d 1367 (9th Cir. 1979), discussed herein, *supra* notes 52 - 53, and the RESTATEMENT (SECOND) OF CONTRACTS § 176 (1981), which states a threat is improper if it is a breach of the duty of good faith and fair dealing. *Farah Mfg.*, 678 S.W.2d at 685.

[228] *Farah Mfg.*, 678 S.W.2d at 686.

[229] *See supra* notes 76 - 78 and accompanying text. For a case enforcing a lender's right to declare a default under a management change clause, see Camelot Ltd. v. Union Mutual Life Insurance Co., 154 Ariz. 330, 742 P.2d 832 (1987).

[230] 331 F. Supp. 698 (N.D. Miss. 1971).

[231] *Id.* at 706-07.

[232] *Id.* at 703.

[233] *Id.* at 706.

evidence that River Valley had lost its free will.[234]

Farah imposed tort liability on the lenders for duress[235] even though duress is not generally recognized as a tort.[236] The remedy for duress is rescission and restitution, not damages.[237] Applying vague standards formulated with a restitution remedy in mind to cases in which actual and punitive damages are sought is inappropriate.[238] In *Farah*, the lenders' statements and threats were fraudulent. Had there been no misrepresentation of intention, the lenders actions would have been legal, since lender approval of management changes was authorized by the loan agreement. Since a fraud remedy for damages was available, the court's finding of duress was surplusage and should not be relied upon as precedent.

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[234] *Id.* at 707; *see also* Adams v. Mark Oil, Inc., 431 So. 2d 489, 490 (Miss. 1983)(quitclaim not induced by threat of prosecution for debts); Bullock v. Green, 224 Miss. 278, 287-88, 80 So. 2d 37, 41 (1955)(refusal to set aside deed of trust on ground procured by threat of prosecution).

[235] *Farah Mfg.*, 678 S.W.2d at 683.

[236] "[D]uress is not in and of itself a recognized tort." DOBBS, *supra* note 215, at 657. *See also* RESTATEMENT (SECOND) OF CONTRACTS, Introductory Note at 474 (1981)("Since duress and undue influence, unlike deceit, are not generally of themselves actionable torts, the victim of duress or undue influence is usually limited to avoidance and does not have an affirmative action for damages."). *But see* Pecos Const. Co. v. Mortgage Inv. Co., 80 N.M. 68, 459 P.2d 842, 843-45 (1969)(permitting recovery of delay damages for duress).

[237] *See, e.g.*, Patterson v. Merchants Truck Line, Inc., 448 So. 2d 288, 289 (Miss. 1984)(action sought rescission of conveyance of property); *see also* RESTATEMENT (SECOND) OF CONTRACTS, Introductory Note at 474 (1981)(avoidance, not damages, is ordinary remedy); DOBBS, *supra* note 215, at 656 (remedies are "essentially restitutionary").

[238] Professor DOBBS explains that the reason damages are not permitted is that duress is conceived in vague terms of morality which, while appropriate for defensive purposes, requires a more limited remedy than damages:

> Hardly any wrongdoing considered in this chapter is defined in terms that will bear the rigorous analysis of a lawyer. That being so, judges have hesitated to impose an affirmative obligation in damages . . . For the most part, the cases here have it in common that the substance behind them being so poorly defined, the remedy is a limited one.

DOBBS, *supra* note 215, at 655. The *Farah Mfg.* court cited Professor DOBBS for the proposition that "restitution (damages)" are recoverable. *Farah Mfg.*, 678 S.W.2d at 683. FMC was awarded actual losses, lost profits and the difference between the market value and the actual value of the FMC assets and equipment sold at auction. Only the latter was restitutionary in nature. *See* DOBBS, *supra* note 215, at 657 (victim of duress entitled to recover value of property taken through coercion when property cannot be returned).

3. Interference

Intentional interference with contracts and prospective business relations is generally recognized as a tort. To impose liability, the proof must establish that the interferer had actual knowledge of the relation interfered with and that the interference was without legal right or justifiable cause. Also, the interference must proximately cause the loss complained.[239] Interference is privileged when undertaken to protect the bona fide interests of the interferer.[240] The scope of this privilege is limited, however. The privilege is lost when the means used to interfere are tortious or otherwise wrongful.[241] The Restatement (Second) of Torts suggests that the question of privilege turns on whether the social benefits expected from permitting the interference are outweighed by the harm flowing from the interference, in other words a "balancing" of interests.[242] The courts are divided on whether the interferer has the burden of proving that the interference was privileged.[243]

The relation interfered with by the lenders' in *Farah* was FMC's right to select its own management.[244] The court found

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[239] *See* In re Knickerbocker, 827 F.2d 281, 287 (8th Cir. 1987)(listing elements of intentional interference); Edwards v. Travelers Ins. Co., 563 F.2d 105, 120 (6th Cir. 1977) (same); Irby v. Citizens Nat'l Bank, 239 Miss. 64, 67, 121 So. 2d 118, 119 (1960)(same); Restatement (Second) of Torts § 766A (1977)(interference with contract); *id.* at § 766B (interference with prospective contractual relations).

[240] The interest can be economic, *e.g.*, Restatement (Second) of Torts § 769 (1977) (financial interest in business induced); *id.* at § 771 (financial stake in business activities of person induced); or legal, *e.g.*, *id.* at § 773 (assertion of bona fide claim).

[241] Walker, *Common Law Protection of Expectancies: 'Business Torts' in Mississippi*, 50 Miss. L.J. 335, 345 (1979). *See also* Restatement (Second) of Torts § 777 (1977) (privilege to interfere in business policy of relation in which the interferer has an economic interest if means employed are not wrongful).

[242] Restatement (Second) of Torts § 767 (1977). *See also* Frank Coulson, Inc. v. General Motors Corp., 488 F.2d 202, 206 (5th Cir. 1974)("The principle issue thus becomes whether the social benefits derived in permitting acts of intervention outweigh the harm to be expected therefrom.").

[243] *Compare* Thompson v. Allstate Insurance Co., 476 F.2d 746, 748 (5th Cir. 1973)(under Alabama law, interferer must prove his actions privileged) *with* Howard v. Chrysler Corp., 705 F.2d 1285, 1287 (10th Cir. 1983)(under Colorado law, plaintiff must establish interference not privileged).

[244] *Farah Mfg.*, 678 S.W.2d at 690. One commentator has suggested that *Farah Mfg.* created a new tort of "interference with choice of management" distinct from the traditional tort of interference with contractual or business relations. Sneed & Athay, *supra*

that the lenders' interference resulted in the election of inexperienced directors and officers whose divided loyalty caused injury to FMC.[245] The court brushed aside the lenders privilege defense because "their conduct failed to comport with the standards of fair play"[246] and because the court concluded the social benefits derived from the interference were outweighed by the harm to be expected from the interference.[247]

Following *Farah*'s lead, three recent federal diversity decisions have held that lenders may be liable in tort for interference with their borrowers' management: *Whitney v. Citibank*,[248] *Melamed v. Lake County National Bank*,[249] and *Citibank, N.A. v. Data Lease Financial Corp.*[250]

In *Whitney*, the lender induced two of three partners in a general partnership to deed partnership property to the lender in lieu of foreclosure. The third partner, Whitney, was unaware of this transaction.[251] The court found that the lender's actions were motivated by a desire to deceive the general partners and to earn a profit on the sale of the property.[252] Additionally, the court noted that the lender knew the third general partner was unsophisticated and that the two partners were acting for themselves in signing the deed and not for the partnership.[253] On these findings, the court upheld a verdict against the lender for

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note 69, at 9 n.72

[245] *Farah Mfg.*, 678 S.W.2d at 688. The interference included (i) the lenders' prevention of Farah's election as C.E.O. and the election of his board candidates; (ii) the lenders' packing of the board with their hand-picked candidates; (iii) the lenders' participation in the selection of two new C.E.O.s; and (iv) the lenders' support of the proxy fight against Farah. *Id.*

[246] *Id.* at 690.

[247] *Id.* at 691.

[248] 782 F.2d 1106 (2nd Cir. 1986).

[249] 727 F.2d 1399 (6th Cir. 1985).

[250] 828 F.2d 686 (11th Cir. 1987). In addition to the cases discussed in the text, see Paradise Hotel Corp. v. Bank of Nova Scotia, No. 87-3318 (3d Cir. March 15, 1988)(Westlaw, Dist file). The *Paradise* court held that a lender wrongfully joining in the filing of a Chapter 7 bankruptcy petition against a borrower may be liable for intentional interference with the borrower's business relations. *Paradise*, No. 87-3318 (Westlaw).

[251] *Whitney*, 782 F.2d at 1109-11. The lenders gave no consideration for the property and partnership law requirements and the partnership agreement were not followed. *Id.* at 1109.

[252] *Id.* at 1117.

[253] *Id.* at 1116-17.

actual and punitive damages.[254]

In *Melamed*, the Sixth Circuit overturned a trial court's grant of summary judgment in favor of a lender on a bankrupt borrower's tortious interference claim. The lender required the borrower to (i) replace its accountant with one selected by the lender, (ii) submit payments to the lender for approval, (iii) cut the pay of its president, and (iv) implement a "13-point program" designed to salvage the lender's losses.[255] On these facts, the court rejected the lender's contention that its actions were privileged and concluded that the issue of interference should have been submitted to the jury.[256]

Citibank, N.A. also overturned a summary judgment granted the lender.[257] The borrower, Data Lease Financial Corp. (Data Lease), pledged its stock in Miami National Bank (MNB) to secure a multimillion dollar loan. The pledge agreement authorized Citibank to vote Data Lease's shares in MNB in the event of a default. When Data Lease defaulted, Citibank used its votes to elect a new board for MNB.[258] Data Lease contended that the new board's interference in Data Lease's rights in the stock caused a dramatic decline in MNB's stock and thus amounted to conversion.[259] The Eleventh Circuit held summary judgment was inappropriate because the control exercised by Citibank over the directors indicated that the directors might have been acting as Citibank's agents.[260]

Other courts have held that a lender's assertion of its rights under the loan agreement is privileged, even though the exercise of those rights interferes with the borrower's business. Illustrative cases are *Flintridge Station Associates v. American Fletcher*[261] and *Del State Bank v. Salmon.*[262]

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[254] *Id.* at 1117-19.

[255] *Melamed*, 727 F.2d at 1403-04.

[256] *Id.*, at 1404.

[257] *Citibank*, 828 F.2d at 690-94.

[258] *Id.* at 689.

[259] *Id.* at 690-91. Data Lease did not base its claim on interference per se, but styled its claim as one for conversion and negligent bailment. *Id.*

[260] *Id.* at 692. For a discussion of the degree of control required to prove agency, see *infra* notes 320-336 and accompanying text. A lender was held liable on interference with a specific contract relation in In re Knickerbocker, 827 F.2d 281, 287-88 (8th Cir. 1987).

[261] 761 F.2d 434 (7th Cir. 1985).

[262] 548 P.2d 1024 (Okla. 1976).

In *Flintridge*, a limited partnership developing a real estate project requested an increase in its construction loan. Since the partnership was in default, the lender conditioned its consent on the partnership disassociating itself from the developer and one of the borrower's general partners who was financially interested in the developer.[263] The court held the lender's conduct was privileged because "[a] lender has a legitimate concern in the management of its borrowers, and consequently in the security of its investments."[264]

In *Del State Bank*, the bank sued to collect on a loan Salmon had used to purchase stock in Amerand, Inc., of which Salmon was president. After this loan was made, the bank used its economic influence and power to squeeze Salmon out of the corporation.[265] Applying the balancing test advocated by the Restatement (Second) of Torts,[266] the court held that the bank's actions were privileged because it had a legitimate economic interest in Amerand, Inc. and because the means it employed to protect its interest were not improper. The court emphasized that the bank's purpose in using its economic power was to further its own financial position, not to wrongfully harm Salmon.[267]

An action for tortious interference with present or prospective contracts is viable under Mississippi law.[268] Mississippi courts also recognize that a lender is privileged to interfere with its borrower's business if such interference is intended to protect

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[263] *Flintridge*, 761 F.2d at 441.

[264] *Id.* at 442.

[265] *Del State Bank*, 548 P.2d at 1025. The other shareholders accomplished the squeeze-out by exchanging their Amerand shares for shares in another entity, which thereafter became the principal shareholder and manager of Amerand. Salmon sought but was refused permission to transfer his stock. *Id.* at 1027.

[266] *Id.* at 1027-28.

[267] *Id.* at 1027. Although the bank used its economic power to influence Amerand's board to end Salmon's employment, its primary objective was to better its financial position, not to wrongfully harm Salmon. *Id.*

[268] *See, e.g.*, Mid-Continent Telephone Corp. v. Home Telephone Co., 319 F. Supp 1176, 1199-1200 (N.D. Miss. 1970)(imposing liability for interference with contract); *see generally*, Walker, *supra* note 241, at 335-72 (thorough discussion of Mississippi case law); Franck, *The Tort of Wrongful Interference with Contracts: A Conflict of Values* 38 MISS. L. INST. 131 (1983)(same).

the lender's legitimate interests. For instance, in *Ross v. Deposit Guaranty National Bank*,[269] a lender's assignment of its security interest in stock pledged to secure a note was deemed privileged interference in the pledgor's ownership rights.[270]

No published Mississippi decision has considered the imposition of liability on a lender for interference in its borrower's management relations. Given lenders' legitimate interests in the operations of its borrowers, Mississippi courts should think twice before following *Farah*'s lead. A lender's interference should be deemed privileged provided the lender's objective is the enforcement of the rights granted by the loan agreement. Lenders should be entitled to pursue these rights as vigorously as any other person in privity with the borrower.

In rare cases, a lender's exercise of its rights may result in the assumption of additional duties and obligations under principles of corporate law. A lender that becomes a de facto director of a borrower arguably should be subject to the duties of a director,[271] including the duties of care[272] and loyalty.[273] Mere

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[269] 400 F. Supp. 45, 152 (S.D. Miss. 1974); *see* Martin v. Texaco, Inc., 304 F. Supp. 498, 502 (S.D. Miss. 1969)("[I]nterference is not wrongful and actionable if undertaken by someone in the exercise of a legitimate interest or right, which constitutes 'privileged interference.' "). There are conflicting federal decisions on whether the interferer has the burden of establishing his actions were privileged under Mississippi law. *Compare* Carter Equip. Co. v. John-Deere Indus. Equip. Co., 681 F.2d 386, 396 (5th Cir. 1982)(burden on plaintiff) *with Mid-Continent Tel.*, 319 F. Supp. at 1200 (N.D. Miss. 1970)(burden on interferer). The former case is consistent with *Irby v. Citizens Nat'l Bank*, 239 Miss. 64, 121 So. 2d 118 (1960) in which the Mississippi Supreme Court held the plaintiff must demonstrate the defendants' interference was "without right or justifiable cause." *Id.* at 67; 121 So. 2d at 119. In *Irby*, the court dismissed a borrower counterclaim alleging that a lender had interfered with certain of his contracts in Louisiana by notifying a Louisiana lender the borrower was in poor financial condition. The borrower contended that as a result of this notification the Louisiana lender cut-off the borrower's working capital which, in turn, caused the abandonment of construction contracts in Louisiana. The court affirmed the trial court's dismissal of the claim because the complaint did not allege the Mississippi lender's actions were without right or justifiable cause or that the Louisiana lender would not have otherwise called its loans. *Id.* at 68; 121 So. 2d at 119.

[270] *Ross*, 400 F.Supp. at 152.

[271] *See* A. HENN & J. ALEXANDER, LAWS OF CORPORATIONS § 206, at 562 (3d ed. 1983)("Anyone assuming to act as a director is subject to the duties of a director.").

[272] Directors and officers of a corporation owe a duty of due care to the corporation in managing its affairs. *Id.* § 234 at 621. The courts are divided on whether the standard for liability is ordinary negligence or gross negligence. Holmes, *The Revised Model Business Corporation Act and Corporate Law Reform in Mississippi: Part One*, 56 MISS. L.J.

errors in business judgment ordinarily do not breach these duties.[274] The court in *Farah* ignored this rule and held the lenders liable for FMC's business losses, even though there was no direct evidence that the officers or directors foisted on FMC by the lenders had breached their duties.

D. Prima Facie Tort

When the facts will not support a case for fraud or interference, some borrowers have attempted to impose liability upon lenders under the prima facie tort theory,[275] also referred to as "abuse of rights."[276] Under this theory, liability may be imposed for an intentional lawful act that was meant to cause injury to

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165, 191 (1986). The Mississippi Business Corporation Act provides that a director must discharge his duties in good faith with the care of an ordinarily prudent person in like circumstances and position and in a manner the director reasonably believes is in the corporation's interest. MISS. CODE ANN. § 79-4-8.30 (Supp. 1987).

[273] Directors and officers of a corporation owe a fiduciary duty of loyalty to the corporation in managing its affairs. HENN & ALEXANDER, *supra* note 271, § 236, at 628. For a discussion of this duty and liability for its breach under Mississippi law, see Hodge & Perry, *The Model Business Corporation Act: Does the Mississippi Version Lime the Bushes?*, 46 MISS. L.J. 371, 386-90 (1975); Holmes, *supra* note 272, at 202-12; Keker & Hunt, *supra* note 94, at 28-38; Comment, *Transactions Between a Corporation and Its Directors: Where Does Mississippi Stand?*, 52 MISS. L.J. 877, 899-95 (1982).

[274] Under the business judgment rule, a director is not liable for an erroneous decision so long as there is a reasonable basis for the decision and the actor acts in good faith uninfluenced by any loyalty other than the director's honest belief in what is in the corporation's best interest. HENN & ALEXANDER, *supra* note 271, § 242 at 661; Holmes, *supra* note 272, at 191.

The authors recognize the admittedly complex issues involved in determining whether officers and directors have fulfilled their corporate duties. *See* Holmes, *supra* note 272, at 195 n.123 (citing numerous scholarly articles dealing with the standard of conduct for directors). Lenders controlling their borrowers, however, should not be held to a greater standard of care than the borrowers' owners, directors and officers.

Authors' supplemental note: *Farah* also ignored the rule that the tort of interference protects contracting parties from interference by a third party not in privity with them. This rule was applied to overturn a jury verdict in favor of a guarantor for interference in Kruse v. Bank of America, to be reported in 201 Cal. App. 3d 354, 248 Cal. Rptr. 217 (1988), a case decided after this article was submitted to the printer. A claim for tortious interference ordinarily cannot be brought by one party to a contract against the other because a contract remedy is available. *See* Ryan v. Brookly Eye and Ear Hospital, 46 A.D.2d 87, 360 N.Y.S.2d 912, 916 (1974).

[275] *See infra* notes 284-295 and accompanying text.

[276] *See* Lambert v. Maryland Cas. Co., 403 So. 2d 739, 755-57 (La. App. 1981)(rejecting abuse of rights claim against surety financing its contractor principal).

another person's property or trade without just cause.[277] Most courts reject this doctrine because it conflicts with the traditional rule that an "improper motive does not operate to make an otherwise lawful act unlawful."[278]

The jurisdictions that recognize the prima facie tort theory have formulated several restrictions on its application. When the complained of conduct is cognizable under an existing tort theory, a prima facie tort action may not be brought.[279] The rationale is that the prima facie tort applies only when the underlying conduct is lawful in itself; when the conduct is tortious, a traditional remedy is available. In addition, "disinterested malevolence" must be shown.[280] When conduct is motivated by legitimate as well as improper purposes, the tort is inapplicable.[281]

The lender liability decisions suggest that the lender's interest in collection of its loan may create an insurmountable barrier to liability under the prima facie tort theory. A trilogy of Missouri appellate cases is demonstrative. In *Centerre Bank*,[282] the

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[277] *Centerre Bank*, 705 S.W.2d at 53-54. RESTATEMENT (SECOND) OF TORTS § 870 (1977) states: "One who intentionally causes injury to another is subject to liability to the other for that injury, if his conduct is generally culpable and not justifiable under the circumstances. This liability may be imposed although the actor's conduct does not come within a traditional category of tort liability." *Id.* The tort has been recognized in the United States since at least 1904. *See* Aikens v. Wisconsin, 195 U.S. 194, 204 (1904)("[P]rima facie, the intentional infliction of temporal damage is a cause of action, which, as a matter of substantive law, whatever may be the form of the pleading, requires a justification if the defendant is to escape.") For an in-depth discussion of the prima facie tort theory, see Note, *The Prima Facie Tort Doctrine in Missouri: Commission of a Lawful Act With Intent to Injure May Result in Liability*, 50 MO. L. REV. 128, 129-36 (1981). Most of the cases construing the prima facie tort doctrine have arisen in Missouri and New York. *See* Annotation, 16 A.L.R. 3d 1191, 1201-31 (1967 & supp. 1987)(listing cases).

[278] Perdue v. J.C. Penney Co., 470 F. Supp. 1234, 1239 (S.D. N.Y. 1979)(applying Texas law); *see also*, Fowler v. Williamson, 39 N.C. App. 715, 251 S.E.2d 889, 892 (1979)("The exercise of a legal right cannot constitute a tort even if there is wrongful intent."); Teas v. Republic Nat'l Bank, 460 S.W.2d 233, 242 (Tex. Civ. App. 1970)(" 'Malicious motives make a bad case worse, but it cannot make that wrong, which, in its own essence, is lawful.' ").

[279] *See* Ruza v. Ruza, 286 A.D. 767, 146 N.Y.S. 2d 808, 810-11 (1985)(rejecting prima facie tort claim on grounds that specific torts were alleged); Advance Music Corp. v. American Tobacco Co., 296 N.Y. 79, 84, 70 N.E.2d 401, 403 (1946)(where specific acts are asserted, doctrine of prima facie tort may not be invoked).

[280] American Bank & Trust Co. v. Federal Reserve Bank, 256 U.S. 350, 358 (1921).

[281] *See infra* notes 294-295 and accompanying text.

[282] *Centerre Bank*, 705 S.W.2d at 42. See *supra* notes 60-64 and accompanying text

court refused to impose liability under the prima facie tort theory on the basis that the lender clearly had a valid business reason for calling the note.[283] In *Rigby Corp. v. Boatman's Bank & Trust Co.*,[284] the court affirmed a grant of summary judgment to the lender on the prima facie tort theory. The court concluded that the bank's interest in collecting a note was a sufficient interest in and of itself to protect the lender, even if the lender's conduct amounted to breach of contract.[285] Finally, in *Shaunnessy v. Mark Twain State Bank*,[286] the court affirmed a trial court's directed verdict on a borrower's prima facie tort claim because there was no evidence that the lender's conduct had a malicious purpose. The court concluded that the mere intent to perform the act that injured the plaintiff was insufficient to impose liability under the prima facie tort theory.[287] Actual "malice," "spite" or "ill will" must be shown.[288]

Although Mississippi has not recognized the prima facie tort by name, Mississippi arguably recognizes the substance of the theory.[289] For example, in *Memphis Steam Laundry-Cleaners, Inc. v. Lindsey*,[290] the Mississippi Supreme Court held that where the purpose of a businesses' price cutting is to destroy its rival rather than compete in the market place, tort relief may be had.[291] Similarly, in *Wesley v. Native Lumber Co.*,[292] the court suggested that an otherwise lawful act becomes unlawful if its purpose is to maliciously injure the business of another person.[293]

No reported Mississippi case discusses the applicability of

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for a discussion of the facts in *Centerre Bank*.

[283] *Centerre Bank*, 705 S.W.2d at 55.

[284] 713 S.W.2d 517 (Mo. Ct. App. 1986).

[285] *Id.* at 545.

[286] 715 S.W.2d 944 (Mo. Ct. App. 1986).

[287] *Id.* at 948-49.

[288] *Id.* at 949 (quoting Dowd v. General Motors Acceptance Corp., 685 S.W.2d 868, 874 (Mo. Ct. App. 1984)).

[289] *See* Walker, *supra* note 241, at 335, 339-42 (discussing cases).

[290] 192 Miss. 224, 5 So. 2d 227 (1941).

[291] *Id.* at 239, 5 So. 2d at 232.

[292] 97 Miss. 814, 53 So. 346 (1910).

[293] *Id.* at 820, 53 So. at 346-47. The defendant intentionally threatened to discharge employees who traded with plaintiff. *Id.*

the prima facie tort theory to lenders.[294] Because lenders always have a legitimate economic interest in the collection of their loans, it is difficult to envision a scenario under which a borrower could recover on a prima facie tort theory of liability. The prima facie tort theory and the theory of good faith and fair dealing suffer from the same fundamental flaw — vagueness.[295]

II. Third Party Theories

Although it was conceivable that a lender might be liable to its borrowers with whom there was a direct contractual relationship, lenders certainly could not foresee that liability to unknown third parties might ever be imposed. In actuality, however, the lender liability cases have taken a turn in that direction.

Third parties in lender liability actions assert the very same theories as borrowers, only from a slightly different perspective. As a result, much of what has been said in Part I of this article regarding borrower theories necessarily applies here as well. The following discussion addresses the various theories in light of the third party approach. The theories are segregated into three groups, based upon factors mutually determinative for liability within each group: (1) the "control" theories, which include instrumentality, alter ego and agency cases; (2) the fiduciary relationship and equitable subordination cases; and (3) the "tort" theories, including fraud and intentional misrepresentation, negligent misrepresentation, and tortious interference with contract.

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[294] The Mississippi Supreme Court came close, however, in National Mort. Co. v. Williams, 357 So. 2d 934 (Miss. 1978). The court affirmed an award of actual and punitive damages for the lenders wrongful foreclosure of a mortgage. The court cited with approval a section of Corpus Juris Secundum stating that a mortgagor is entitled to recover damages when a "foreclosure is attempted solely from a malicious desire to injure the mortgagor." *Id.* at 935 (quoting 59 C.J.S. *Mortgages* § 491 at 774 (1949)). The reported facts and the court's discussion, however, indicated that liability was imposed for the mortgagee's malicious breach of its obligations under the mortgage. *Id.* at 935-37. The prima facie tort theory presumes recovery is not available on any other legal theory. *See supra* note 280 and accompanying text.

[295] See *supra* notes 89-90 and accompanying text.

A. *The Control Theories — Instrumentality, Alter-ego and Agency*

A common allegation in lender liability cases is that the lender assumed control over the debtor to such an extent that the lender should be liable for the actions and obligations of the debtor. Regardless of whether the cause of action is asserted under a theory of "instrumentality", "alter-ego", or "agency", the determining issue is still the same: did the lender control the borrower?[296] If so, the lender may be liable. The key lies in how

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[296] One author views the various theories as lying on a spectrum of creditor conduct based on control: the shared control and possibly shared profit cases, such as partnership and joint venture cases, lie at one end of the spectrum; the agency cases rest in the middle; and finally the cases involving domination of the borrower, such as instrumentality and alter ego cases, occupy the opposite end of the spectrum. Schechter, *supra* note 11, at 931-32.

Third parties might also attempt to impose liability against a lender under a joint venture theory. Specifically, third parties could allege that a bank which finances operations or loans money to a business occupies a position as a joint venturer in that business and should, therefore, be liable for the debts and obligations of the business. In Mississippi, however, such an assertion will be difficult to sustain. Under Mississippi law, two elements are essential to find a joint venture relationship: (1) an agreement, either express or implied from the conduct of the parties, and (2) the parties must share the profits of the activity. Hernando Bank v. Bryant Elec. Co., 357 F. Supp. 575, 584 (N.D. Miss. 1973). The mere fact the bank receives interest on funds loaned to the business should not constitute a "sharing of profits" so as to impose liability. *See* Edwards v. Northwestern Bank, 39 N.C. App. 261, 250 S.E.2d 651, 661 (1979), *aff'd on appeal after remand*, 53 N.C. App. 492, 281 S.E.2d 86 (1981)(court ruled no joint venture existed because of lack of sharing of control and profits; no profit sharing existed because lender entitled to receive only principal amount plus normal rate of interest). One author argues the presence or absence of profit sharing should not be dispositive of the issue of liability:

> It is true that a controlling creditor not sharing in the profits generally receives no compensation beyond that set out in the initial agreement. However, to view the contractually established compensation as both a ceiling and a floor is to ignore the realities of the typical control situation. As the cases discussed thus far show, control rarely arises at the time the debtor firm is established. Typically, once the debtor encounters financial difficulties, its existing major secured creditor decides to salvage as much as possible rather than to foreclose immediately on inadequate and depreciated collateral. At the time the decision to assume control is made, the creditor is almost always badly undersecured. The compensation for control, indeed the motivation for control, is the prospect that the salvage operation will increase the value of the collateral before the debtor collapses. The benefit sought by the creditor — the net enhancement of the collateral or paydown of the debt during the period of control — often is far more substantial than profit sharing would be, especially when the

much "control" the court requires before imposing liability. In the landmark decision, *Krivo Industrial Supply Co. v. National Distillers & Chemical Corp.*,[297] the United States Court of Appeals for the Fifth Circuit held virtual total control was required.

Krivo addressed the liability of a lender under the instrumentality theory to creditors of its borrower. In *Krivo*, ten creditors sued the primary creditor, National Distillers, after the debtor corporation, Brad's Machine Products, Inc. (Brad's), became insolvent.[298] Bridgeport Brass Company (Bridgeport), a division of National Distillers, was the major supplier of brass for Brad's.[299] When Brad's unpaid open account reached approximately one million dollars, Brad's and Bridgeport entered into a "financing and loan agreement."[300] As a result, Bridgeport agreed to continue to supply Brad's with brass, provided shipments were paid for within a specified time.[301] Notwithstanding the new payment arrangement, Brad's financial condition worsened and the Government threatened to cancel its fuse contract with Brad's. Brad's and National Distillers adopted a plan to financially salvage Brad's,[302] which later became the foundation

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debtor is deeply insolvent and unprofitable. Thus, the shibboleth of profit sharing ought not be determinative of liability.

Id.

[297] 483 F.2d 1098 (5th Cir. 1973), *modified*, 490 F.2d 916 (5th Cir. 1974).

[298] *Id.* at 1101.

[299] *Id.* at 1107. In 1966, John C. Bradford, the owner of Brad's, decided to enter into the munitions industry and employed Arnold Seitman to assist in entering the Government contracting market. Seitman successfully obtained a $2.7 million contract for Brad's to produce M-125 fuses. Bradford invented a new method for producing the fuses, primarily composed of brass, and thereby "revolutionized" the industry. *Id.* As a result, the M-125 fuses became Brad's major product, constituting ninety percent of Brad's gross sales. *Id.* By 1969, Bridgeport was supplying $400,000-$500,000 of brass rods each month to Brad's. *Id.*

[300] *Id.* at 1108. Under the agreement, Bridgeport accepted a promissory note, personally guaranteed by Bradford and his wife. Additionally, certain real property owned by a subsidiary of Brad's was mortgaged to Bridgeport as collateral for the loan. *Id.* at 1107. The note required monthly payments of $40,000, plus interest, and a final balloon payment in March 1970. *Id.* at 1107-08. However, the note could be extended in the event Brad's successfully contracted with the Government prior to April 1, 1970 to supply additional fuses. *Id.* at 1108.

[301] *Id.* Brad's was required to pay for shipments within 15-16 days, with a 10 day grace period. *Id.*

[302] *Id.*

for a suit against National Distillers under the instrumentality theory.[303] Pursuant to the plan, National Distillers was to perform five primary functions: (i) provide internal financial management assistance to Brad's, (ii) loan Brad's an additional $600,000 cash, (iii) extend the time in which Brad's must repay an additional $630,000 account receivable, (iv) assist in a liquidation of unprofitable holdings, and (v) persuade the Government not to cancel its fuse contract with Brad's.[304] Despite these efforts, Brad's financial situation became hopeless and Brad's ceased operations.[305] Thereafter, ten unpaid creditors sued National Distillers for payment of money owed by Brad's, contending that National Distillers should be liable for Brad's debts under the instrumentality theory.[306] On appeal, the Fifth Circuit affirmed the district court's directed verdict in favor of National Distillers, holding the evidence insufficient to establish the required control for imposition of the instrumentality theory.[307]

The importance of the *Krivo* decision rests with the rigorous standards the Fifth Circuit laid down before liability to a third party attaches under the instrumentality theory.[308] In strong

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[303] *Id.* at 1109.

[304] *Id.* at 1108. In accordance with this plan, National Distillers accepted a note for the $600,000 cash loaned and the $630,000 account receivable owed. As collateral, National Distillers took a security interest in Brad's plant, furniture and equipment. *Id.* Additionally, Brad's assigned to National Distillers certain stock and leases for liquidation, the proceeds of which were to be given to Brad's for working capital. *Id.* National Distillers also assigned two of its employees to Brad's: an internal auditor to supervise finances and to establish controls over cash and investments, and another employee to assist in disposal of assets. *Id.*

[305] *Id.* at 1109.

[306] *Id.* at 1101. The instrumentality rule provides that "when one corporation controls and dominates another corporation to the extent that the second corporation becomes the 'mere instrumentality' of the first, the dominant corporation becomes liable for those debts of the subservient corporation attributable to an abuse of that control." *Id.*

[307] *Id.*

[308] The court analyzed the facts in light of two essential elements for application of the instrumentality theory: (1) control, and (2) damage to the plaintiff through misuse of that control. *Id.* at 1103. In examining control, the court analogized to situations wherein one corporation has an ownership interest in another corporation. *Id.* at 1104. The court noted that evidence of ownership does not "per se" determine the issue of control. *Id.* Likewise, the court noted that lack of ownership will not "per se" abrogate the issue of control where "actual and total control has been otherwise established." *Id. But cf.* Lundgren, *supra* note 11, at 532 ("[T]he court may have been overly influenced by the

language, the Fifth Circuit ruled that something much greater than a mere creditor-debtor relationship must be proven to establish the requisite control for liability under the instrumentality theory:

> The general rule is that the mere loan of money by one corporation to another does not automatically make the lender liable for the acts and omissions of the borrower. [citations omitted]. The logic of this rule is apparent, for otherwise no lender would be willing to extend credit. The risks and liabilities would simply be too great. Nevertheless, lenders are not automatically exempt from liability under the "instrumentality" rule. If a lender becomes so involved with its debtor that it is in fact actively managing the debtor's affairs, then the quantum of control necessary to support liability under the "instrumentality" theory may be achieved.
>
> An examination of "instrumentality" cases involving creditor-debtor relationships demonstrates that courts require a strong showing that the creditor assumed *actual, participatory, total control of the debtor. Merely taking an active part in the management of the debtor corporation does not automatically constitute control, as used in the "instrumentality" doctrine, by the creditor corporation.*[309]

The court concluded that the control necessary to hold a creditor liable under the instrumentality theory is a "total domination of the subservient corporation, to the extent that the subservient corporation manifests no separate corporate interests of its own and functions solely to achieve the purposes of the dominant corporation."[310]

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instrumentality cases involving debts between parent and subsidiary corporations.")

[309] *Krivo*, 483 F.2d at 1104-05 (emphasis added).

[310] *Id.* at 1106. In FMC Finance Corp. v. Murphree, 632 F.2d 413 (5th Cir. 1980), the guarantor of payments under a lease agreement asserted that the corporate entity should be disregarded and responsibility imposed upon the subsidiary for the acts of the parent corporation. *Id.* at 420. Citing *Krivo*, the *Murphree* court noted that a control amounting to total domination must exist to impose liability upon a parent corporation for the acts of a subsidiary. *Id.* at 422. However, where the plaintiff seeks to impose liability upon a subsidiary for acts of the parent, the court ruled that total domination is not required. Instead, only a "control relationship" between the two entities is necessary. *Id.* The court held that an "implied misrepresentation in the extension of credit" would be sufficient to impose liability upon the subsidiary, stating:

A creditor has the duty to first ascertain the creditworthiness of the corpora-

In applying the aforementioned standards to the facts of the case, the court concluded that National Distillers had exercised no greater control than any creditor would typically do in a creditor-debtor relationship.[311] At most, National Distillers had acted in a reasonable manner to safeguard its interests and had not assumed the "actual, participatory, total control" necessary to impose liability under the instrumentality doctrine.[312] In so ruling, the Fifth Circuit correctly determined that lenders have legitimate interests that should be protected. Before such rights can be defeated, a high degree of control, wrongfully used, must be proven.

The *Krivo* ruling was expressly relied upon in *Irwin & Leighton, Inc. v. W.M. Anderson Co.*,[313] a recent decision ad-

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> tion he voluntarily deals with, and assumes the risk of possible default by that corporation when he extends credit . . . When the shareholder or affiliate, however, engages in conduct likely to create in the creditor the reasonable expectation that he is extending credit to an economic entity larger than the corporation he actually contracted with, and the creditor reasonably relies to his detriment on his reasonable belief concerning who or what he was dealing with, then the corporate veil can be pierced.

Id. at 423 (citations omitted). As a result, any lender affiliated with a corporation should insure that persons dealing with the corporation realize that two distinct entities are involved. *See, e.g.*, Divco-Wayne Sales Fin. Corp. v. Martin Vehicle Sales, Inc., 45 Ill. App. 2d 192, 195 N.E.2d 287, 289-90 (1963)(parent manufactured vehicles; subsidiary financed sales of parent's vehicles).

[311] *Krivo*, 483 F.2d at 1110. Although stock ownership is not conclusive of control, the court considered whether National Distillers held an ownership interest in Brad's. The plaintiff creditors alleged ownership. However, the evidence showed only that National Distillers may have *intended* at one point in time to accept an assignment of stock, but that such assignment had never been consummated. *Id.* at 1109. The court found no substance in plaintiffs' allegations that National Distillers threatened to fire and replace officers and employees of Brad's, finding instead that National Distiller's control was limited to its ability to monetarily control Brad's. *Id.* at 1110. The court also rejected plaintiffs' contentions that National Distillers had assumed direct control over Brad's day-to-day operations. *Id.* The court ruled that employees placed on the job site by National Distillers served narrow purposes. For example, the internal auditor's function was to control purchases and disbursements. *Id.* at 1111. As such, the internal auditor implemented certain controls. Although approval of purchases was required, such approval was not required in all instances and it was never denied where the purchase served a legitimate business purpose. *Id.* Other National Distiller's employees assigned to Brad's were determined only to be engaged in offering advice, assisting where needed in production, and otherwise fulfilling tasks (such as disposal of assets) to which Brad's had freely agreed. *Id.* at 1112.

[312] *Id.* at 1110.

[313] 532 A.2d 983 (Del. Ch. 1987).

dressing the liability of a surety, active in the financing and management of a troubled debtor, to a third party. The surety, Fidelity and Deposit Company of Maryland (Fidelity), had not bonded the particular job in question. However, the plaintiff nevertheless asserted, among other allegations, that the surety had controlled the contractor to such a degree that principles of alter ego should apply and the surety be deemed liable for the contractor's breach of contract.[314]

When the contractor, Anderson, became financially distressed, Fidelity, with complete and voluntary consent of Anderson, engaged CMA to review Anderson's financial affairs and to make recommendations. CMA determined that Fidelity would suffer a loss of approximately $17,000,000 on bonded projects if Anderson shut down. In lieu thereof, Fidelity retained CMA to monitor Anderson's financial affairs and assist in the day to day financial operations.[315]

After Anderson's unsuccessful attempt to obtain bank financing, Fidelity extended a loan to Anderson, secured by a joint control and trust agreement. The terms of the agreement required receipts on bonded and unbonded projects to be segregated. Receipts on bonded projects could be spent only on bonded projects, and, although Anderson retained power to select the particular bills to be paid, such payments were subject to final approval by Fidelity. Additionally, Fidelity obtained a security interest in Anderson's properties.[316]

The court refused to impose liability upon Fidelity, stating that a creditor cannot be held liable for the debtor's obligations "[w]here, as here, the third party creditor became involved with

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[314] *Id.* at 984. The evidence established that the troubled debtor, W.M. Anderson Co. (Anderson), had contracted with Irwin & Leighton, Inc. (Irwin) to perform as mechanical subcontractor on a government project. Due to substantial financial difficulties, Anderson defaulted on the job. Irwin sued Anderson and Fidelity and Deposit Company of Maryland ("Fidelity") for the damages it incurred as a result of the default. *Id.* In addition to the alter ego theory, the plaintiff asserted that Fidelity had wrongfully interfered with Anderson's contractual obligations and had violated a particular Delaware statute. *Id.*

[315] *Id.* at 985. CMA was actively involved in developing an accounting system for Anderson, meeting with Anderson personnel to review and approve payments on bonded jobs, etc. CMA, however, never became involved in unbonded projects. *Id.* at 990.

[316] *Id.*

the corporation as the result of an arms-length extension of credit or other arms-lengths transactions and thereafter comes to exercise control over the debtor by reason of a default or threatened default."[317] The court ruled that Anderson had maintained its separate corporate identity and that any power Fidelity possessed over Anderson resulted solely from the agreement

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[317] *Id.* at 989, citing *Krivo*. The court also expressly relied upon the decision in McFadden, Inc. v. Baltimore Contractors, Inc., 609 F. Supp. 1102 (E.D.Pa. 1985). In *McFadden*, a subcontractor sought payment from USF&G, a bonding company, for construction work performed pursuant to an agreement with Baltimore Contractors, Inc. (Baltimore). *McFadden*, 609 F. Supp. at 1103. Although USF&G had not bonded the construction project in question, it had bonded several other major construction projects by Baltimore. *Id.* Baltimore became financially distressed and USF&G realized it could lose up to $50,000,000 if it assumed completion of the bonded projects for Baltimore. *Id.* In lieu thereof, USF&G entered into an agreement with Baltimore by which USF&G loaned Baltimore $20,000,000 for funding of its operations. *Id.* Certain conditions, discussed hereinafter, were included in the agreement to protect USF&G's position as a major creditor of Baltimore. *Id.* In its suit against USF&G, it was this agreement which the subcontractor used to assert that USF&G had assumed control of Baltimore and should therefore be liable for Baltimore's debts under the instrumentality theory. *Id.* at 1104.

The court ruled the question whether Baltimore had become the instrumentality of USF&G was one of law for the court. *Id.* Citing *Krivo*, the *McFadden* court determined that USF&G could not be liable under the instrumentality theory, as it had not taken "absolute and total control of Baltimore." *Id.* at 1105. The court rejected the subcontractor's contentions that the conditions of the loan agreement evidenced a domination by USF&G over Baltimore. For example, the court found that the provisions requiring assignment of Baltimore's future payments to USF&G were merely imposed to insure payment on the loan. *Id.* at 1106. The requirement that USF&G approve certain payments by Baltimore was merely a control measure to insure that loaned funds were properly used for bonded projects. *Id.* Similarly, the agreement to furnish USF&G with a monthly accounting of unbonded projects and the requirement that Baltimore obtain USF&G's written consent before entering into any new construction contracts were justified measures to monitor Baltimore's activities and to minimize USF&G's risks. *Id.* at 1106-07. Even though Baltimore granted an irrevocable power of attorney to USF&G which allowed USF&G to complete bonded projects, the court found that such power in no way authorized USF&G to control unbonded projects or projects bonded by other surety companies. *Id.* at 1107. *But see* Schroeder, *supra* note 69, at 1208 ("While [a power of attorney] is a fine idea in theory, it is simply one more factor which can lead to a claim of domination by the principal, or to a claim of alter-ego liability by third parties."). Finally, the court rejected the contention that USF&G's refusal to bond new contracts of Baltimore until a new chief executive officer was hired constituted domination. *McFadden*, 609 F. Supp. at 1108. In light of Baltimore's financial distress, the court considered it reasonable to require confidence in the chief executive officer who would be running the company. *Id.* Considering all the evidence, the court concluded that USF&G had not exercised "total and actual control" over Baltimore and therefore could not be liable under the instrumentality theory. *Id.*

which had been negotiated at arms length.[318] The court concluded that the plaintiff had chosen to contract with Anderson without requiring a bond and should therefore be the party to bear the loss.[319]

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[318] *Irwin & Leighton*, 532 A.2d at 990.

[319] *Id.* The court reasoned that the fact that "Anderson Co.'s creditors came to exercise influence or even dominating practical power over Anderson Co., can, in these circumstances, provide to Irwin no substitute for the surety bond it did not obtain." *Id.* In contrast to *Irwin* and *McFadden*, a surety successfully asserted the instrumentality theory as a *defense* to liability under a bond in Neese v. Fireman's Fund Ins. Co., 53 Tenn. App. 710, 386 S.W.2d 918 (1964). In *Neese*, the trustee in bankruptcy for First Trust Company sued Fireman's Fund Insurance Company (Fireman's), the surety on a bond for Real Estate Management, Inc. (REMCO). *Id.* at 918. The suit arose after Fireman's refused to pay a claim filed by First Trust on the grounds that REMCO and First Trust were so closely connected that the two should be treated as one legal entity. *Id.* at 919.

The evidence of control in *Neese* was overwhelming. One shareholder and his immediate family owned more than seventy percent of the outstanding stock in both REMCO and First Trust. *Id.* Additionally, the primary shareholder, Scott Brown, held offices as president, chairman and treasurer for both corporations. Brown regulated the financial affairs so tightly that he approved all payments in excess of $100. *Id.* Ten of REMCO's directors also served as the directors for First Trust. With only one exception, both corporations had the same elected officers, appointed officers, and executive committees. *Id.* at 919-20. The two corporations were jointly operated, and even occupied the same office space. "The two companies had the same address and the same phone number; there was overlapping of personnel; office materials and supplies were stored together; hiring for both companies was usually done by the same person; until the end of 1961, all employees of both companies were paid on checks of REMCO; after that, on checks of First Trust Company." *Id.* at 920. Finally, numerous financial transactions were executed between the two corporations. Any debt owed from one company to the other was recorded in an "intercompany note account" and evidenced by a written document, but no attempt was ever made to collect such notes. *Id.* The court concluded that the aforementioned evidence proved a domination "so complete that neither corporation had any mind, will or existence of its own." *Id.* at 922. The court considered the proof in light of the discussion of the instrumentality doctrine as set forth in 1 FLETCHER CYC. CORP. § 43 (perm. ed. 1963), which states:

> "A very numerous and growing class of cases wherein the corporate entity is disregarded is that wherein it is so organized and controlled, and its affairs are so conducted, as to make it merely an instrumentality, agency, conduit, or adjunct of another corporation. The control necessary to invoke what is sometimes called the 'instrumentality rule' is not mere majority or complete stock control but such domination of finances, policies and practices that the controlled corporation has, so to speak, no separate mind, will or existence of its own and is but a business conduit for its principal. * * * One corporation may be disregarded where the two are identical or indistinguishable in fact. Unless it is a mere instrumentality or agency or adjunct in that sense, or as a sham or is used in fraud, by the dominant corporation, it will not be disregarded; and it will not be disregarded unjustly."

Neese, 386 S.W.2d at 921. *But see* Continental Bankers Life Ins. Co. v. Bank of Alamo,

Third parties have enjoyed more success in imposing liability on lenders by use of the agency theory. Unlike the court in *Krivo*, the Supreme Court of Minnesota in *A. Gay Jenson Farms Co. v. Cargill, Inc.*[320] imposed liability against a lender under an agency theory.[321] In *Jenson*, eighty-six farmers sued the lender, Cargill, Inc., for a $2 million indebtedness[322] owed by Warren Grain & Seed Co.[323] to the farmers. The court affirmed the jury verdict that Cargill had become the principal and War-

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578 S.W.2d 625, 631, 632 (Tenn. 1979)("We do not agree that the *Neese* court intended the quote from 1 FLETCHER CYC. CORP. § 43 (perm. ed 1963) to define the elements of proofs required to invoke the instrumentality rule in Tennessee"; court set forth three elements of instrumentality doctrine: (1) total domination, (2) use of control to commit wrongful act, and (3) proximate cause of injury). The court ruled that the two corporations were " 'identical or indistinguishable in fact,' " and that First Trust could not recover on the bond. *Neese*, 386 S.W.2d at 922; *see also* Tennessee Consol. Coal Co. v. Home Ice & Coal Co., 25 Tenn. App. 316, 156 S.W.2d 454, 456 (1941)(claim of insurance company against Home Ice & Coal Co. subordinated to claims of other creditors on basis that Home Ice was so dominated as to be agent or instrumentality of insurance company; evidence showed that insurance company made loan on real estate and assumed control over property and its operations after abandonment of debtor.) *But see Continental Bankers*, 578 S.W.2d at 627 (bank asserted instrumentality theory as defense in suit by subsidiary corporation for recovery of certificate of deposit applied against loan balance due to bank from parent corporation; court ruled that bank had failed, as matter of law, to meet burden of establishing one-corporation defense so as to justify disregard of corporate entities).

[320] 309 N.W.2d 285 (Minn. 1981).

[321] *Id.* at 291. The RESTATEMENT (SECOND) OF AGENCY § 1(1)(1958) defines agency as "the fiduciary relationship which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." Authors Ebke & Griffin have said that the *Jenson* decision implicitly recognizes a fiduciary duty by a controlling creditor to a debtor, the benefits of which extend to any person harmed by misuse of that relationship. Ebke and Griffin, *supra* note 9, at 794. However, Ebke and Griffin comment that, in view of "the inherent propensity of agricultural states to protect the interests of farmers", the *Jenson* decision may be limited to its facts and its effect not so encompassing. *Id. See generally* Kunkel, *The Fox Takes Over the Chicken House: Creditor Interference With Farm Management*, 60 N.D.L. REV. 445 (1984).

[322] *A. Gay Jenson Farms*, 309 N.W.2d at 289-90.

[323] *Id.* at 288. Warren Grain & Seed Co. (Warren) operated a grain elevator and engaged in the business of grain storage for local farmers, as well as cash purchases of grain for resale. *Id.* Cargill, Inc. (Cargill) loaned money to Warren for working capital. In exchange, Warren appointed Cargill as its grain agent for transactions with a certain credit corporation and also granted a first right of refusal to Cargill for the purchase of grain. *Id.* Although the amount of financing initially was limited to $175,000, Cargill consistently increased its financing until Warren's indebtedness to Cargill at the time it ceased operations reached $3.6 million. *Id.* at 288-89.

ren its agent,[324] citing nine factors supporting such finding,[325] including such apparently innocuous acts as Warren's use of preprinted forms bearing Cargill's name; Cargill's recommendations to Warren by phone and by letter, etc.

The *Jenson* court paid lip service to the traditional lender/debtor relationship, implying that the result would have been different if the lender had been a bank.[326] The court considered

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[324] *Id.* at 291. The RESTATEMENT (SECOND) OF AGENCY § 14 O (1958) provides: "A creditor who assumes control of his debtor's business for the mutual benefit of himself and his debtor, may become a principal, with liability for the acts and transactions of the debtor in connection with the business." *Id.* This section takes on greater meaning when read in connection with its Official Comment, which states:

> a. A security holder who merely exercises a veto power over the business acts of his debtor by preventing purchases or sales above specified amounts does not thereby become a principal. However, if he takes over the management of the debtor's business either in person or through an agent, and directs what contracts may or may not be made, he becomes a principal, liable as a principal for the obligations incurred thereafter in the normal course of business by the debtor who has now become his general agent. The point at which the creditor becomes a principal is that at which he assumes de facto control over the conduct of his debtor, whatever the terms of the formal contract with his debtor may be.
>
> Where there is an assignment for the benefit of creditors, the latter may become the principals of the assignee if they exercise control over transactions entered into by him on their behalf.

Id. at comment a.

The *Jenson* court expressly relied upon the language of § 14 O and its corresponding comment in imposing liability. *A. Gay Jenson Farms*, 309 N.W.2d at 291.

[325] *A. Gay Jenson Farms Co.*, 309 N.W. 2d at 291. The court listed the following factors as evidence of the agency relationship:

> (1) Cargill's constant recommendations to Warren by telephone;
> (2) Cargill's right of first refusal on grain;
> (3) Warren's inability to enter into mortgages, to purchase stock or to pay dividends without Cargill's approval;
> (4) Cargill's right of entry onto Warren's premises to carry on periodic checks and audits;
> (5) Cargill's correspondence and criticism regarding Warren's finances, officers' salaries and inventory;
> (6) Cargill's determination that Warren needed "strong paternal guidance";
> (7) Provision of drafts and forms to Warren upon which Cargill's name was imprinted;
> (8) Financing of all Warren's purchases of grain and operating expenses; and
> (9) Cargill's power to discontinue the financing of Warren's operations.

Id.

[326] *Id.* at 292. The court expressly stated that, as to lenders, "[t]he decision in this case should give no cause for concern." *Id.* Several organizations, including the Northwestern National Bank of Minneapolis, submitted amicus curiae briefs to the court. *Id.*

Cargill's business to be "markedly different from an ordinary bank financing, since Cargill was an active participant in Warren's operations rather than simply a financier."[327]

The *Jenson* court placed too much emphasis upon the classification of the lender. All lenders have justifiable interests which should be protected. The *Jenson* court disturbed the rights of lenders by imposing liability under a lesser standard than that set forth in *Krivo*. In essence, the *Jenson* court allowed the plaintiffs to circumvent the rigorous, yet proper, standards of *Krivo* by phrasing the cause of action in terms of "agency" rather than "instrumentality." Despite the theory asserted, control is the key issue. The standards applied and the results reached should be identical, irrespective of whether the theory is instrumentality, agency, or alter ego.

The Texas Court of Civil Appeals refused to allow the agency theory to be used to impose liability upon a lender in *Lane v. Dickinson State Bank*.[328] Allegedly, plaintiff Lane was employed by Maritime Group Companies, Inc., (Maritime) pursuant to a written five year employment agreement. After only eighteen months of employment, Lane was discharged. Lane sued Maritime for wrongful breach of contract.[329] Additionally, Lane sued Dickinson State Bank and its president under the theory of corporate alter ego.[330] Lane alleged that the bank and its president had dominated Maritime, running Maritime as if it were their own company, and ultimately resulting in Maritime's destruction.[331] In support of his allegations, Lane asserted that the bank had loaned $60,000 to Maritime, falsely declaring that the maturity date was five to seven years when, in fact, the note became due after only one year.[332] Furthermore, Lane alleged

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at 290. These amicus curiae briefs asserted that, if the jury decision were affirmed, banks would refuse to make future loans to grain elevators. *Id.* at 292.

[327] *Id.* at 292-93. The court concluded that "[a]lthough considerable interest was paid by Warren on the loan, the reason for Cargill's financing of Warren was not to make money as a lender but, rather, to establish a source of market grain for its business."

[328] 605 S.W.2d 650 (Tex.Civ.App. 1980).

[329] *Id.* at 651.

[330] *Id.* at 652.

[331] *Id.* at 651, 652, and 653 n.1.

[332] *Id.* at 651. As a result, the loan was successively renewed in a series of ninety-day notes. *Id.*

that the president had assigned his personal accountant to Maritime and required the accountant's signature on all corporate checks.[333] In addition to applying corporate funds without Maritime's consent to reduce the indebtedness to the bank, Lane also contended that the president arranged additional funding for Maritime from a company the president controlled.[334] As a matter of law, the court held that Lane failed to assert a claim upon which relief could be granted.[335] The court ruled that the alter ego theory is inapplicable in a situation "where the individuals are not alleged to be shareholders, incorporators, directors, or officers of the target corporation."[336]

In 1975, the Mississippi Supreme Court adopted the doctrine of piercing the corporate veil and the instrumentality rule.[337] In *North American Plastics, Inc. v. Inland Shoe Manufacturing Co.*,[338] a Mississippi federal court reviewed Mississippi law and articulated a set of ten factors to be considered in determining if the instrumentality rule applies:

> (1) The parent corporation owns all or a majority of the capital stock of the subsidiary. (2) The parent and subsidiary corporations have common directors or officers. (3) The parent corporation finances the subsidiary. (4) The parent corporation subscribes to all the capital stock of the subsidiary or otherwise causes its incorporation. (5) The subsidiary has grossly inadequate capital. (6) The parent corporation pays the salaries or

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[333] *Id.*

[334] *Id.* at 651-52.

[335] *Id.* at 653.

[336] *Id.* Despite its ruling, the court acknowledged that a cause of action may lie against a third party who influences a corporation and causes harm to an individual. However, the court considered Lane's pleadings, and concluded that he had not alleged any fraudulent acts against him by the bank, nor that the bank had caused his discharge, nor that the bank's "allegedly fraudulent activity caused the financial condition of Maritime to deteriorate to the point that his discharge became necessary." *Id.* The court emphasized Lane's pleading that the fraud committed by the bank and its president had caused the destruction of Maritime, "not that it caused financial ruin." *Id.* at 653 n.1. The court reasoned that, rather than causing any harm to the corporation, Maritime may have succeeded in staying in business as long as it did only as a result of the bank's continued cooperation and financing. *Id.* at 653.

[337] Johnson & Higgins of Miss., Inc. v. Commissioner of Ins., 321 So. 2d 281, 285 (Miss. 1975).

[338] 592 F. Supp. 875 (N.D. Miss. 1984).

> expenses or losses of the subsidiary. (7) The subsidiary has substantially no business except with the parent corporation or no assets except those conveyed to it by the parent corporation. (8) In the papers of the parent corporation and in the statements of its officers, "the subsidiary" is referred to as such or as a department or division. (9) The directors or executives of the subsidiary do not act independently in the interest of the subsidiary but take direction from the parent corporation. (10) The formal legal requirements of the subsidiary as a separate and independent corporation are not observed.[339]

These factors are consistent with the *Krivo* requirements and are equally applicable in lender liability actions based on theories of agency or alter ego.

With respect to claims founded on agency principles, Mississippi follows the strictures of *Krivo* and *North American Plastics, Inc.* The United States District Court for the Northern District of Mississippi laid the proper foundation for lender liability in Mississippi when it refused to impose a principal/agent relationship on the financier in *XYOQUIP, Inc. v. Mims*.[340] The plaintiff, XYOQUIP, Inc., (XYOQUIP) was engaged in the business of financing the lease of Freezie Slush drink machines. Under the leasing arrangement, Freezie Corporation, through its employee, Frady, would submit a signed lease, a letter of acceptance acknowledging receipt of the machines, and certain financial data regarding the lessee to XYOQUIP. Additionally, Freezie Corporation would prepare a bill of sale for the machines to XYOQUIP. If the documents were approved, XYOQUIP would sign the lease, thereby closing the transaction.[341]

The defendants entered into a lease agreement for twenty machines, which was approved for financing and paid by XYOQUIP. Despite the signed letter acknowledging receipt of twenty machines in acceptable condition, defendants later notified XYOQUIP that only four machines had been delivered, all of which were defective. Defendants refused to make any lease payments,

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[339] *Id.* at 879.

[340] 413 F. Supp. 962 (N.D. Miss. 1976).

[341] *Id.* at 963-64.

and XYOQUIP brought suit to recover.[342]

Defendants denied liability for the lease payments, asserting that Frady had negotiated the transaction as the agent — either actual, apparent or implied — of the financier, XYOQUIP. The court, however, rejected the contention that an agency relationship existed,[343] quoting three elements required before an agency relationship can be found: "a manifestation of the principal, by either his words or conduct or both, that the agent shall act for him, the agent's acceptance of the undertaking, and, most critically, the understanding of the parties that the principal is to be in control of the undertaking."[344]

The court found that the aforementioned elements had not been satisfied to impose an agency relationship. The court noted that Frady was an employee of Freezie Corporation and never held himself out as acting on behalf of XYOQUIP. In fact, except to the extent that XYOQUIP's name appeared on the forms used, the defendants had no knowledge of plaintiff's existence until subsequent to the closing of the transaction. The court correctly ruled that use of plaintiff's forms, alone, was insufficient to impose an agency relationship since "[s]uch a practice is common in the commercial community."[345] The court determined that, at most, XYOQUIP financed the sale of machines by Freezie Corporation and supplied Freezie with the forms to accomplish such transactions.[346]

Likewise, the court rejected plaintiff's contentions that an implied agency existed, holding that plaintiff's conduct had not evidenced an intention to create such a relationship;[347] neither did the court find any apparent authority to act, stating that apparent authority cannot exist where there is no actual, express, or implied agency relationship.[348]

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[342] *Id.* at 965.

[343] *Id.* at 966.

[344] *Id.*. at 965, *citing* 2A C.J.S. Agency § 36.

[345] *Id.*

[346] *Id.* at 965-66.

[347] *Id.* at 966.

[348] *Id.* The court restated the law regarding apparent authority:

A principal, having clothed his agent with the semblance of authority, will not be permitted, after others have been led to act in reliance of the appearances thus produced, to deny, to the prejudice of such others, what he has thereto-

Thus, the law in Mississippi is established that overwhelming control must be proven before liability can be imposed against a lender. This remains true whether the cause of action is founded on the instrumentality doctrine, alter ego, or agency theories.

B. Fiduciary Theories and Equitable Subordination

The decisions in the agency cases discussed previously are influenced in part by the concept of a fiduciary relationship. The Restatement (Second) of Agency section 14 defines an agency as "the fiduciary relation which results from the manifestation of consent by one person to another that the other shall act on his behalf and subject to his control, and consent by the other so to act." When a fiduciary relationship exists, a lender may owe duties to other creditors of the borrower, as well as to the borrower itself, and may be liable for any breaches of such duties.[349]

Mississippi has not yet imposed a fiduciary obligation upon lenders to third parties. However, under general corporate principles, fiduciary obligations have been imposed upon directors and shareholders of corporations. In *Love Manufacturing Co. v. Queen City Manufacturing Co.*,[350] the court ruled that directors of an insolvent corporation cannot prefer themselves by using corporate assets to pay debts owed to them. The court reasoned that "[t]o permit it would be to allow those intrusted with the governing power of a corporation to prefer themselves by their own determination and action, —a proposition monstrous in the extreme, shocking to the moral sense, and wholly indefensible, as it seems to us. . . ."[351]

Since general corporate principles are extensively relied

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fore tacitly affirmed as to the agent's powers. There are three essential elements to apparent authority: (1) *Acts or conduct of the principal*; (2) reliance thereon by a third person; and (3) a change of position by the third person to his detriment. All must concur to create such authority.

Id. (emphasis added).

[349] The RESTATEMENT (SECOND) OF TORTS § 874 (1979) states: "One standing in a fiduciary relation with another is subject to liability to the other for harm resulting from a breach of duty imposed by the relation." *Id.*

[350] 74 Miss. 290, 20 So. 146 (1896)(action to set aside assignment for benefit of creditors under which certain directors and shareholders became preferred creditors).

[351] *Id.* at 147; *see also* Keker & Hunt, *supra* note 94, at 28-29 (discussion of *Love*).

upon in analyzing the lender liability theories, it can be inferred that, under the *Love* ruling, a lender could be classed as a fiduciary. However, the strict requirements of *Krivo* should apply before a lender is determined to be a fiduciary. Lenders have an independent, bargained-for interest to protect and should be allowed to assert all rights granted by loan agreements to protect such interests.

Accordingly, the Mississippi Supreme Court has indicated that a high standard must be met before a lender will be classed as a fiduciary to third parties. In *Champion International Corp. v. First National Bank*,[352] a seller of goods brought suit against a bank for fraudulent and negligent misrepresentation regarding the credit worthiness of its customer. Additionally, the seller sought to impose a form of fiduciary obligation upon the bank by imposition of a constructive trust for the benefit of the seller upon funds in the bank.[353] Although the court's language expressly referred to a "constructive trust", the same principles should apply in imposing any form of fiduciary duty. Specifically, the court ruled:

> A constructive trust is one that arises by operation of law against one who, by fraud, actual or constructive, by duress or abuse by any form of unconscionable conduct, artifice, concealment, or questionable means, or who in any way against equity and good conscience, either has obtained or holds the legal right to property which he ought not, in equity and good conscience, to hold and enjoy.[354]

The court properly held that mere negligence would not be sufficient to impose a constructive trust.[355]

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[352] 642 F. Supp. 237 (S.D. Miss. 1986).

[353] *Id.* at 239.

[354] *Id.* at 243.

[355] *Id.*; *cf.* Central Bank v. Butler, 517 So. 2d 507, 512 (Miss. 1987)(court upheld award of actual and punitive damages where bank offset funds known to be held in trust for third party against individual indebtedness of depositor); Vickers v. First Miss. Nat'l Bank, 458 So. 2d 1055, 1062 (Miss. 1984)(court reversed summary judgment in favor of defendant bank, holding that bank owed direct contractual obligation, as opposed to fiduciary obligation, to shareholder individually); Armour-Cudahy Packing Co. v. First Nat'l Bank, 69 Miss. 700, 11 So. 28, 29 (1892)(where bank had notice that funds in customer's account were held for benefit of third party, bank's subsequent application of such funds to pay customer's overdrafts were at peril of bank and jury question existed

The Mississippi Supreme Court expressly refused to recognize any fiduciary obligations between competing banks. In *Citizens National Bank v. First National Bank*,[356] Citizens National Bank (CNB) asserted the theory of fiduciary duty against First National Bank (FNB) in an effort to hold FNB liable for losses suffered by CNB as the result of a check kiting scheme by a mutual customer. CNB alleged that FNB became aware of the check kiting scheme in March or April, 1974. Thereafter, without informing CNB of the customer's scheme, FNB commenced to return all checks presented for payment which had been drawn on FNB and deposited with CNB. At the same time, however, FNB continued to accept checks drawn on CNB as deposits, which were then presented to CNB and paid.[357] CNB alleged that FNB accumulated such funds with the purpose of applying such funds to debts owed FNB. CNB further alleged that such actions were wrongful in that the funds were owned by CNB and that FNB had obtained such funds by "false pretense, conversion, or misappropriation."[358]

The Mississippi Supreme Court refused to impose a fiduciary duty on FNB. The court noted that the two banks were competitors. The court found no facts to support a confidential or fiduciary relationship between the banks, nor any requirement in the bank industry that one bank notify another bank of such unlawful customer practice. As such, the court held that FNB was under no duty to inform CNB of the customer's scheme and, additionally, that FNB had a legal right to refuse payment of checks drawn on it while continuing to present CNB checks for payment.[359]

Another form of fiduciary theory, generally applied in the

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whether bank had misappropriated funds).

[356] 347 So. 2d 964 (Miss. 1977).

[357] *Id.* at 966.

[358] *Id.*

[359] *Id.* at 967. The court likewise rejected CNB's allegations that FNB had acted fraudulently. Since there was no duty to disclose the scheme, FNB's actions could not constitute a fraud. The court found no representations by FNB to indicate that CNB had been wrongfully induced to pay checks drawn on it. *Id.* at 969. The court also discussed ownership of the funds and concluded that once CNB paid the checks FNB became the owner of the funds and therefore could not be liable for conversion or misappropriation. *Id.* at 968.

bankruptcy context, is that of equitable subordination of the lender's claims.[360] In 1939, the United States Supreme Court handed down two leading decisions addressing equitable subordination: *Taylor v. Standard Gas & Electric Co.*[361] and *Pepper v. Litton.*[362]

Taylor sets forth what has come to be commonly known as the "Deep Rock Doctrine." Petitioners, the trustee in bankruptcy and certain preferred stockholders of Deep Rock Oil Corporation (Deep Rock), protested a claim filed by Standard Gas & Electric Co. (Standard) as creditor.[363] The petitioners asserted that the transactions leading up to the debt owed to Standard were fraudulent and that Deep Rock had become the agent or instrumentality of Standard, thereby precluding Standard from asserting a claim as a creditor.[364]

The evidence established that Standard completely controlled Deep Rock, not only through majority ownership of the common stock but also through common officers and directors. The Court found that through this control Standard had the opportunity to mismanage Deep Rock, and did so.[365] The Court

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[360] *See, e.g.*, In re Bowman Hardware & Elec. Co., 67 F.2d 792, 794 (7th Cir. 1933)(lender's claim subordinated to that of another creditor for failure to disclose debt upon inquiry by creditor); In re American Lumber Co., 7 Bankr. 519, 529 (Bankr. D. Minn. 1979), *aff'd*, 5 Bankr. 470, 478 (D. Minn. 1980)(bank's claim subordinated to that of general creditors on ground debtor's grant of security interest in inventory and equipment to bank constituted fraudulent conveyance). For an excellent comparison of the agency theory with the fiduciary theory, see Schechter, *supra* note 11, at 937-39 (proposes that standard for liability under fiduciary theory should be stricter since creditor may be liable in tort, as well as be required to "undo its former dealings", whereas alter ego theory imposes liability only for debtor's obligations).

[361] 306 U.S. 307 (1939).

[362] 308 U.S. 295 (1939).

[363] *Taylor*, 306 U.S. at 311.

[364] *Id.* at 312. The court commented that the "instrumentality rule" is not technically a rule, but rather an equitable principle which allows disregard of the corporate entity where to do otherwise would work a fraud or injustice. The court noted that the principle is properly applied "to give minority stockholders redress against wrongful injury to their interests by a majority stockholder." *Id.* at 322. The court held that § 77B of the Bankruptcy Act protects shareholders in the same manner. *Id.*

[365] *Id.* at 310. For example, dividends were paid at times when cash was unavailable, thereby requiring Deep Rock to borrow large sums of money from Standard. *Id.* at 317. The court alluded to the possibility that such dividends were paid to keep the voting power of the preferred shareholders from arising, since the preferred shareholders had no voting rights unless dividends were in arrears six months. *Id.* at 320 n.4. When Deep

concluded that the preferred shareholders had asserted injury resulting from the control and mismanagement by Standard, and that Standard's interest in the assets of Deep Rock would be subordinated, or reduced to a secondary status, to that of the preferred shareholders.[366]

In *Pepper*, the court affirmed the subordination of the controlling shareholder's claim based on a finding that the shareholder had engaged in a "planned and fraudulent scheme" to deprive another creditor of her just debt.[367] The Court ruled that a controlling shareholder occupies a fiduciary capacity.[368] Actions by such a fiduciary can be set aside or subordinated, but "[t]he essence of the test is whether or not under all the circumstances the transaction carries the earmarks of an arm's length bargain."[369]

Rock needed to refinance its debt obligations, Standard accepted common stock in order to eliminate the large credit balance owing to Standard at that time. *Id.* at 321.

[366] *Id.* at 324.

[367] *Pepper*, 308 U.S. at 312. Pepper brought suit against the corporation for an accounting of certain lease royalties. Thereafter, the controlling shareholder, Litton, sued the corporation for five years of accumulated and unpaid salary claims. Litton caused the corporation to confess a judgment for his claims. Finally, after Pepper obtained a judgment, Litton obtained a suspension of the judgment to allow time for an appeal. However, in lieu of appealing, Litton executed upon his own judgment during the period of suspension. *Id.* at 297. At a sheriff's sale, the corporate property was sold to Litton, with Litton promptly reselling the property at a value more than six times higher than Litton had paid. *Id.* at 298. Litton thereafter caused the corporation to file voluntary bankruptcy and Litton purchased wage claims against the corporation in an attempt to make it appear that Pepper was the only creditor. *Id.* at 298-99.

[368] *Id.* at 306.

[369] *Id.* at 306-07. The court stated:

> [A] sufficient consideration [whether claims will be subordinated] may be simply the violation of rules of fair play and good conscience by the claimant; a breach of the fiduciary standards of conduct which he owes the corporation, its stockholders and creditors. He who is in such a fiduciary position cannot serve himself first and his *cestuis* second. He cannot manipulate the affairs of his corporation to their detriment and in disregard of the standards of common decency and honesty. He cannot by the intervention of a corporate entity violate the ancient precept against serving two masters. He cannot by the use of the corporate device avail himself of privileges normally permitted outsiders in a race of creditors. He cannot utilize his inside information and his strategic position for his own perferment. He cannot violate rules of fair play by doing indirectly through the corporation what he could not do directly. He cannot use his power for his personal advantage and to the detriment of the stockholders and creditors no matter how absolute in terms that power may be and no matter how meticulous he is to satisfy technical reuqirements. For that

Since *Taylor* and *Pepper*, the courts have outlined three essential conditions for application of the equitable subordination principles:

> (i) The claimant must have engaged in some type of inequitable conduct;
> (ii) The misconduct must have resulted in injury to the creditors of the bankrupt or conferred an unfair advantage on the claimant;
> (iii) Equitable subordination of the claim must not be inconsistent with the provisions of the Bankruptcy Act.[370]

Under the foregoing standards, mere proof of a fiduciary relationship is insufficient to subordinate a claim.[371] However, "inequitable conduct" sufficient to support subordination includes fraud, illegality, breach of fiduciary duties, undercapitalization, or use of the debtor as an instrumentality or alter ego.[372]

In the construction loan context, the Mississippi Supreme Court in *Peoples Bank & Trust Co. v. L & T Developers, Inc.*[373] set forth a test for determining when equitable subordination is appropriate. The two prong test requires proof that a significant amount of the funds disbursed by the lender did *not* actually go into the construction project and that the construction lender failed to use reasonable diligence to assure that the funds being disbursed were actually being used for the project.[374]

Where equitable subordination is applied, the appropriate remedy is to counter the harm that other creditors suffered as a result of the inequitable conduct by shifting the priority of the wrongful party's claim below that of innocent creditors. When

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> power is at all times subject to the equitable limitation that it may not be exercised for the aggrandizement, preference, or advantage of the fiduciary to the exclusion or detriment of the *cestuis*. Where there is a violation of those principles, equity will undo the wrong or intervene to prevent its consummation.

Id. at 310-11.

[370] In re Mobile Steel Co., 563 F.2d 692, 700 (5th Cir. 1977)(citations omitted).

[371] In re Missionary Baptist Found. of Am., 712 F.2d 206, 212 (5th Cir. 1983).

[372] *Id.*

[373] 434 So. 2d 699 (Miss. 1983).

[374] *Id.* at 707; *see also* In re Century Inns, Inc., 59 Bankr. 507, 525-26 (S.D. Miss. 1986)(equitable subordination denied where neither *Peoples Bank* test nor *Mobile Steel* test satisfied).

properly applied, the doctrine of equitable subordination is intended to merely undo the advantage obtained over other creditors by the wrongdoing party.[375]

The doctrine is not penal in nature. Therefore, monetary damages are inappropriate. For this reason, commentators have suggested that "courts may be more willing to find control when the consequences of that finding will be less severe."[376] However, in certain instances, the courts have exceeded the intent of the doctrine and ordered that the wrongful party's claim be subordinated to the claims of *all* other creditors, irrespective of whether such other creditors suffered harm.[377] The result, for all practical purposes, is the equivalent of a monetary award.[378]

One commentator, Leo Clarke, has analyzed the concept of a fiduciary obligation as it applies in a leveraged buyout situation.[379] Clarke proposes that control should be the focal point for a determination whether a fiduciary obligation exists.[380] Clarke notes that typically a leveraged creditor will take a security interest in the debtor's assets, require a pledge of stock, and most probably impose certain affirmative or negative covenants upon the operation of the debtor's business. In Clarke's opinion, such covenants constitute sufficient control to impose a fiduciary obligation if management's power to handle changing circum-

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[375] *See generally* DeNatale & Abram, *The Doctrine of Equitable Subordination as Applied to Nonmanagement Creditors*, 40 Bus. Law. 417, 423 (1985)("[T]he goal should be merely to offset the harm done to other creditors and not to punish the offending creditor for his wrongful conduct.").

[376] Schechter, *supra* note 11, at 880 n.12. Schechter notes that the effect is the same as a monetary award if the debtor is gravely insolvent and the lienholders who attain higher priority have claims equal to or in excess of the assets released by the subordination. *Id.*

[377] *See, e.g.*, In re Process-Manz Press, Inc., 236 F. Supp. 333 (N.D. Ill. 1964), rev'd on other grounds, 369 F.2d 513 (7th Cir. 1966), *cert. denied* 386 U.S. 975 (1967). For a discussion of the punitive nature of subordination, see Chaitman, *The Equitable Subordination of Bank Claims*, I ABA 127, 137-142 (1987).

[378] *See* Chaitman, *supra* note 377, at 130-144 (discussion of subordination as remedy).

[379] Clarke, *supra* note 97, at 423 (1984). A leveraged buyout is a method of acquiring a company with a minimal investment as compared to the purchase price. Generally, outside lenders fund the purchase price, and the assets of the acquired company stand as collateral for the debt. The borrower is often the acquired company itself. *Id.* at 423, n.1.

[380] *Id.* at 427.

stances is restricted.[381] Likewise, Clarke considers the typical lender to be a fiduciary, based upon the lender's ability to exercise powers pursuant to the loan agreement.[382]

Clarke's theory fails to give proper accord to the fact that loan agreements are entered into based on arms' length negotiations, with attendant bargained for consideration. Clarke states "[a] basic assumption underlying the fiduciary principle is that a party with any choice would not enter into a relationship in which it becomes subject to the control of another unless it believed there were some inherent limits on that control."[383] However, by the same token, a basic premise underlying the lending process is that the financier would not enter into a creditor/debtor relationship unless it believed it had certain rights available to protect its interests.[384]

The lender/borrower relationship, standing alone, should never create a fiduciary relationship under Mississippi law. As discussed throughout this section, the lender must somehow misuse his status to the detriment of a third party. The "misuse" required for liability must be egregious, and not merely an exercise of rights inherent in the creditor/debtor relationship.

C. The Tort Theories

1. Fraud and Intentional Misrepresentation

Where control is absent and fiduciary principles or equitable subordination are inapplicable, theories of fraud and/or intentional misrepresentation have been asserted in an attempt to impose liability against lenders. However, as evidenced by the decision in *Union Bank v. Belk*,[385] the underlying philosophy of *Krivo* remains alive. Lenders cannot be expected to go to the

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[381] *Id.* at 439.

[382] *Id.* at 452. "They [lenders] are fiduciaries because the covenants and the security interest give them control over the corporate enterprise and over the interest of other persons in that enterprise." *Id.* Clarke further states that "the more stringent the covenants, the more control the creditor has, and the more likely it is that the creditor is a fiduciary to at least some interest in the corporation." *Id.* at 439.

[383] *Id.* at 434.

[384] *See also* Keker & Hunt, *supra* note 94, at 38-48 (1983)(discussion of liability of non-fiduciaries).

[385] 510 F. Supp. 1117 (W.D.N.C. 1981).

grave with a dying corporation. The lender justifiably can protect its interests and limit its exposure. As such, substantial adverse acts by the lender must be proven to warrant disturbing the lender's rights to protect its interests. In *Union Bank*, Union Bank of Bavaria (UBB) sued the personal guarantor of a $2,000,000 loan to Avery's, Inc.[386] The guarantor, Belk, raised the affirmative defense that the bank had induced his personal guaranty through fraudulent misrepresentations.[387] Specifically, Belk asserted that UBB had promised to make a $3,000,000 long-term revolving loan to Avery's, Inc. when, in fact, at the time the representations were made, UBB had no intention of making such loan, and that such misrepresentations had damaged Belk. The court noted that promises to make future loans are actionable as fraud only if the promisee changes his position in reliance thereon. "A mere broken promise does not constitute fraud."[388] Assuming *arguendo* that Belk's contentions were true, the court ruled that UBB's promise had "little relevance" to the guaranty — i.e., Belk could prove no reliance on the loan commitment promise. Instead, the court found that Belk had signed the guaranty at a time when Avery's Inc. was already in default in order to prevent financial disaster of the corporation. The court thought it inconceivable to charge the bank with fraud for "deciding that it had pumped enough of its capital into an ailing corporation."[389]

The United States Court of Appeals for the Second Circuit likewise rejected allegations of fraud and misrepresentation against a bank in *Ford v. C.E. Wilson & Co.*[390] In *Ford*, the plaintiff, a supplier of roses, sued the bank after it failed to receive payment for a shipment to C.E. Wilson & Co. (Wilson).[391] The evidence established that about one week prior to the shipment Wilson applied for a $6,500 loan from the bank. Although

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[386] *Id.* at 1119. After Avery's, Inc. defaulted on a $2,000,000 loan to the bank, UBB obtained a personal guaranty from Belk and J. Richard Avery for the principal and interest owed on the indebtedness in the sum of $2,086,305.56. *Id.*

[387] *Id.* Belk also asserted other defenses to the action.

[388] *Id.*

[389] *Id.* at 1120.

[390] 129 F.2d 614 (2d Cir. 1942).

[391] *Id.* at 615.

Wilson provided the bank with a financial statement which indicated that Wilson was solvent, the bank nevertheless demanded several forms of security as a condition to loaning the money,[392] all of which were agreed to by Wilson. When Wilson defaulted on the bank's loan, the bank applied accounts receivable collections against the balance owed and foreclosed on Wilson's equipment.[393] Plaintiff sued the bank, alleging two primary counts based on interference with contract[394] and fraud.[395]

As to the claim of fraud, the court rejected the plaintiff's argument that the bank had concealed its plan whereby it induced Wilson to receive the roses with the intention that the shipment never be paid for. The court found no evidence that the bank had knowledge of Wilson's insolvency, and concluded that, even if the bank had reason to believe that Wilson could not pay for the roses, such belief was not indicative of any intent not to pay.[396] Finally, the court summarily rejected the plaintiff's contentions that the pledges and assignments were fraudulent in that the bank had concealed its preferential position from other creditors, stating:

> There was no requirement that the Bank should notify the creditors that it held assignments of accounts receivable. The failure to notify them or even the desire not to have the assignments known was not a fraud when unaccompanied by any representation to the creditors that it did not hold the

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[392] *Id.* The bank required Wilson to (1) lease the basement and a room on the main floor of Wilson's warehouse to the bank, (2) pledge all equipment, nursery stock and chattels, then owned and after acquired, to the bank, (3) assign all accounts receivable, including future accounts to the bank, (4) allow the bank's agent to take possession of the leased property and all pledged property, and (5) deposit all accounts receivable payments in a special account with a trust company. *Id.*

[393] *Id.* at 616.

[394] *See infra* notes 430-441 and accompanying text.

[395] *Ford*, 129 F.2d at 616. Plaintiff's fraud count asserted that the bank had concealed the existence of the pledges, assignments, and lease from creditors, and that the bank had loaned the $6,500 to Wilson for the sole purpose of keeping his business alive for a four month period in order that the foregoing transfers would not be voided as unlawful preferences. Plaintiff also asserted that the bank had "fraudulently made it appear that Wilson was a solvent going concern, by operating the business in the name of Wilson when the latter's property had been in fact appropriated by the Bank." *Id.*

[396] *Id.*

security.[397]

Like the courts in *Union Bank* and *Ford*, Mississippi requires clear and convincing proof to establish fraud.[398] Fraud is difficult to prove and the absence of any element in the cause of action results in failure of the claim.[399]

Although allegations of fraudulent misrepresentation are universally difficult to sustain, the plaintiff in *Central States Stamping Co. v. Terminal Equipment Co.*[400] successfully proved such assertions and obtained a jury verdict of $50,000, which was affirmed on appeal. The evidence established that the plaintiff contacted a bank officer to inquire about a company from whom the plaintiff contemplated placing an order for a specially manufactured machine. The plaintiff contended that it made a down payment of $30,000 and one progress payment of $20,000 for the machine based on the bank's representations that the manufacturing company was "maintaining a satisfactory credit relationship with the Bank and was trustworthy."[401] The plaintiff proved that, at the time the representations were made by the bank, the manufacturing company was in fact in default on two loans with the bank and its financial stability uncertain.[402] To aggravate the situation, the plaintiff also proved that the bank had benefited from its false statements in that the $30,000 payment by the plaintiff was used by the bank to offset debts owed by the manufacturing company.[403]

The bank appealed the adverse judgment on the grounds that a "misrepresentation" could not be based on a failure to disclose, unless some duty to disclose existed.[404] The court sum-

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[397] *Id.* at 618.

[398] Franklin v. Lovitt Equip. Co., 420 So. 2d 1370, 1373 (Miss. 1982). *See supra* notes 196-199 (discussion of elements of fraud).

[399] *See, e.g.*, Champion Int'l v. First Nat'l Bank, 642 F. Supp. 237, 241 (S.D. Miss. 1986)(plaintiff's allegations of fraudulent misrepresentations failed where plaintiff did not establish bank's knowledge of falsity of statements, nor intent that plaintiff rely on statements, nor damages resulting from alleged reliance).

[400] 727 F.2d 1405 (6th Cir. 1984). *See supra* note 167 and accompanying text.

[401] *Central States Stamping*, 727 F.2d at 1407.

[402] *Id.* at 1408.

[403] *Id.* at 1409.

[404] *Id.* at 1408. The bank also asserted that its statements could at most constitute an opinion, which could not be used as the foundation for a fraudulent misrepresenta-

marized the law as follows: "The duty to speak does not depend on the existence of a fiduciary relationship between the parties. It may arise in any situation where one party imposes confidence in the other because of that person's position, and the other party knows of this confidence."[405] Of special relevance was the fact the bank benefited from the plaintiff's action. The court stated "[t]he duty [to disclose] is particularly clear when the party answering the inquiry benefits directly from the actions of the inquiring party."[406] The court concluded the bank had actual knowledge that the plaintiff considered the requested credit information material to its decision and that the plaintiff would rely on the bank's response in making a purchase decision. As such, the court ruled the bank had a duty to disclose all information in its knowledge which would be considered material to the plaintiff's decision.[407]

2. Negligent Misrepresentation

Where an intended misrepresentation cannot be established, third parties still have one avenue for relief — the theory of negligent misrepresentation. The polestar lender liability decision addressing negligent misrepresentation is the Mississippi case, *Berkline Corp. v. Bank of Mississippi*.[408]

In *Berkline Corp.*, a creditor[409] sued the bank for actual and

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tion. *Id.* The court disagreed, finding that the bank's statement that the manufacturing company was meeting its commitments to the bank, when in fact it was in default, was a misrepresentation of fact. The court further remarked that "where there has been a failure to disclose fully accompanied by a duty to speak, statements of favorable opinion may have the effect of lulling the inquirer into a less searching probe." *Id.* at 1409.

[405] *Id.*

[406] *Id.*

[407] *Id.* Relying on an English case, the court reasoned that a bank faced with a credit inquiry has three options: (1) refuse to answer, (2) give a qualified answer, denying all responsibility for the response, or (3) give an unqualified answer. Where the bank gives an unqualified answer, the bank "can be held to have accepted some *responsibility* for answering carefully or to have accepted a *relationship* with the inquirer which requires him to exercise such care as circumstances require." *Id.* (emphasis added). "Responsibility" apparently refers to an expectation that the bank will exercise reasonable care in answering inquiries, while the "relationship" imposed by answering apparently refers to the confidence reposed in the bank by the inquirer.

[408] 453 So. 2d 699 (Miss. 1984).

[408] *Id.* at 700. The creditor, Berkline Corporation, was a Delaware corporation en-

punitive damages,[410] allegedly suffered as a result of a credit report prepared by the bank regarding one of its customers.[411] The creditor asserted that the credit report included material false statements,[412] the creditor relied on such report in extending credit to the customer,[413] and suffered losses as a direct result thereof.[414]

The Circuit Judge dismissed the case, ruling that in a claim for fraudulent misrepresentation, the elements of fraud must be proved.[415] However, the Mississippi Supreme Court reversed and remanded for trial on a negligent misrepresentation theory.[416] The court concluded that a bank has no duty to provide credit references for customers and can incur no liability for refusing

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gaged in the wholesale business of furniture to retailers for resale. *Id.*

[410] *Id.* at 701.

[411] *Id.* at 699. The customer was Furniture City, Inc., a Tennessee corporation engaged in the retail sale of furniture. Furniture City, Inc. did its banking business at a branch of the Bank of Mississippi in Olive Branch, Mississippi. *Id.* at 700.

[412] *Id.* at 700. The credit report furnished to Berkline Corp. stated that Furniture City had a line of credit with the bank in the low six figure range, a savings account in the low six figure range, and a commercial checking account with an average balance in the low five figure range. *Id.* At trial, Berkline Corp. introduced evidence that there were in fact no savings and checking accounts as stated by the bank, and further that Furniture City was indebted to the Bank in the amount of $50,000-$60,000. *Id.* at 701.

[413] *Id.* Essentially, Berkline Corp. contended it would not have sold goods to Furniture City on credit if it had known the true status of Furniture City's financial affairs. *Id.*

[414] *Id.* at 700-01.

[415] *Id.* at 701; *see supra* notes 196-199 and accompanying text.

[416] *Belkline*, 453 So. 2d at 703. The court identified the elements of a claim for negligent misrepresentation:

> (a) A misrepresentation or omission of a fact;
> (b) That the representation or omission is material or significant;
> (c) That in responding to the credit inquiry the bank officer failed to exercise that degree of diligence and expertise the public is entitled to expect of reasonably competent bank officers;
> (d) That it reasonably relied upon the bank's misrepresentation or omission; and
> (e) That it suffered damages as a direct and proximate result of such reasonable reliance.

Id. at 702; *see also* White v. Hancock Bank, 477 So. 2d 265, 271 (Miss. 1985)("Fundamental requisites to a claim for negligent misrepresentation is that the party making the representation did so under circumstances where he has been engaged to make the representation and reasonably should be foreseen that the other would rely substantially thereon."; court found no "engagement" where plaintiff did not seek financial advice from bank and plaintiff had personal attorney present at closing).

to do so.[417] However, where a bank does act, even though without compensation, it must use that degree of care and diligence expected by the public of a reasonable bank officer;[418] otherwise, the bank may be subject to liability.[419]

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[417] *Berkline Corp.*, 453 So. 2d at 702.

[418] *Id.* The United States District Court for the Southern District of Mississippi discussed the degree of care and diligence expected of bank officials in Champion International Corp. v. First National Bank, 642 F. Supp. 237 (S.D. Miss. 1986). The court ruled that the bank officers failed to exercise reasonable care and diligence where they failed to communicate with one another regarding the availability of a letter of credit for a customer. *Id.* at 242.

[419] *Berkline Corp.*, 453 So. 2d at 702. The court noted that because of the bank's "unique position to know of the customer's credit worthiness", banks know or should know that third parties will rely upon credit information supplied by the bank. *Id.* As such, banks have an obligation to insure that representations are accurate. *Id.*

In reaching its conclusion, the Mississippi Supreme Court relied upon Nevada National Bank v. Gold Star Meat Co., 89 Nev. 427, 514 P.2d 651 (1973) and Anchor Lumber Corp. v. Manufacturers' Trust Co., 242 A.D. 656, 272 N.Y.S. 610 (1934). In *Nevada National Bank*, Gold Star Meat Co. made a credit inquiry to Nevada National Bank regarding Holiday Ranch Beef, Inc. *Nevada National Bank*, 514 P.2d at 652. After the bank responded that Gold Star could safely extend up to $8,000 credit to Holiday Ranch Beef, Gold Star delivered two shipments of beef. However, Holiday Ranch's check in payment for the beef was returned, marked "insufficient funds." *Id.* at 653. Gold Star later discovered that on the date of the credit inquiry Holiday Ranch had no account with Nevada National Bank, although its parent corporation did have a deposit account. *Id.* at 652. A judgment in favor of Gold Star against the bank for the amount of the check plus attorneys' fees was affirmed. *Id.* at 654. The court ruled that where a bank responds to a credit inquiry it has a duty to reply with correct information and may be liable where negligence or carelessness causes a misrepresentation of facts within the bank's knowledge. *Id.* at 653-54. The court noted that the bank "could have requested written authorization for such a disclosure with attendant releases and disclaimers." *Id* at 653; *see also* Union Bank v. Safanie, 5 Ariz. App. 342, 427 P.2d 146, 151 (1967)(bank held liable to stock brokerage firms for falsely stating that depositor's check for purchase of stock would clear through bank account; court ruled that "where the defendant had adopted a practice of imparting credit information to local businessmen, it should not complain that plaintiffs ought not to have trusted such information, unless such trust was manifestly unreasonable"); *Anchor Lumber Corp.*, 272 N.Y.S. at 611 ("We think there was a duty, in view of the bank's relations to the public, to speak carefully when the defendant's employee undertook to speak at all. The inquiry of the bank clearly imported a merchant's purpose to rely upon the information, and rely upon it it did to its loss."); Gartner v. American Nat'l Bank, 58 So. 2d 705, 708 (Fla. 1952)(summary judgment granted to defendant bank where plaintiff alleged loss as result of bank employee's representations that depositor's checks were as good as gold). *But see White*, 477 So. 2d at 270 (alleged statement by bank official that check " 'looked all right to him or that he saw nothing wrong with it or something of that nature' " held to be opinion); Bullard v. Citizens Nat'l Bank, 173 Miss. 450, 160 So. 280, 282 (1935)(statement by bank officer that bonds sold to customer were "gilt-edged and as good as gold" held to be mere statement of opinion and inactionable against bank); Albion Milling Co. v. First Nat'l Bank,

The Mississippi Supreme Court imposed liability on a bank for negligent misrepresentation in *Shogyo International Corp. v. First National Bank.*[420] First National Bank of Clarksdale (FNBC) issued a letter of guaranty to Shogyo in behalf of Co-Products Unlimited, Inc. (Co-Products), for which Shogyo supplied Co-Products with an initial order of wheel casters.[421] On two subsequent occasions, the same system was used to place additional orders — i.e., Co-Products notified FNBC that an order of casters was needed, FNBC issued a letter of guaranty to Shogyo, and Shogyo thereafter shipped the goods to Co-Products.[422]

On February 5, 1980, Co-Products submitted a purchase order to Shogyo for 150,000 wheel casters on "usual" terms.[423] Thereafter, on February 19, 1980, FNBC sent a letter to Shogyo stating that Co-Products had made financial arrangements with the bank for the purchase of the casters.[424] In a letter to FNBC dated March 4, 1980, Shogyo outlined its understanding of the Bank's guarantee for the casters, and requested that FNBC initial and return the letter. Although FNBC did not respond, shipments of the casters were nevertheless made. The Bank refused payment for the shipments, and Shogyo filed suit to re-

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64 Neb. 116, 89 N.W. 638, 640 (1902)(bank cashier told proposed supplier of merchandise that to his knowledge customer seemed to be doing well, that all debts were paid, and that credit extension of about $500 would probably be good; court held such statements could only be considered an expression of opinion and supplier was able to form his own opinion regarding extension of credit since cashier fully disclosed all information he knew); Taylor v. Commercial Bank, 174 N.Y. 181, 66 N.E. 726, 729-30 (1903)(court ruled that bank employee had no apparent or implied authority, by virtue of position as cashier, to make any representations on behalf of bank as to solvency of customer and bank could not be held liable for damages resulting from such representations). For an interesting, yet unsuccessful, attempt to impose liability on a bank for credit information under a theory of malicious interference with contractual relations, see Irby v. Citizens National Bank, 239 Miss. 64, 121 So. 2d 118 (1960).

[420] 475 So. 2d 425 (Miss. 1985).

[421] *Id.* at 425.

[422] *Id.* at 426.

[423] *Id.* "On 'usual' terms" was understood by Shogyo and Co-Products to mean guaranteed by FNBC. *Id.*

[424] *Id.* In full, the letter stated "Co-Products Limited, Inc. has made financial arrangements with us to purchase 150,000 casters at $.43 each in shipments of 50,000. It is our understanding the first shipment will arrive in June. We appreciate your working with Co-Products Limited, Inc. on this matter." *Id.*

cover payment.[425]

FNBC contended its letter was not one of guaranty, but only a letter of thanks to Shogyo for granting credit to Co-Products. FNBC further contended that it would not have issued a letter of guaranty because at the time the letter was written Co-Products was in poor financial condition and no arrangements had been made for financial assistance.[426]

The court held that the elements of negligent misrepresentation, as set forth in *Berkline Corp.*, were satisfied. The court determined the Bank's statement that Co-Products had made financial arrangements for the purchase of the casters was an untrue statement of fact which the bank should have known Shogyo would act upon.[427] As such, FNBC was under a *duty* to disclose the information necessary to correct its prior misrepresentations.[428]

Berkline Corp. and *Shogyo* are warnings to Mississippi lenders: even though allegations of control or fiduciary obligations are impossible, lenders may nevertheless be liable to third parties for statements or omissions made in the course of business. The absence of compensation to the bank for such representations is irrelevant. Therefore, as an avoidance technique to liability, lenders should assert disclaimers when supplying credit information and/or obtain releases of liability from the person or entity to whom the information is provided.[429]

3. Tortious Interference With Contract

Third parties have also attempted to impose liability on lenders for interference with their own contractual relationship with the borrower. As in the borrower liability cases discussed earlier, the decisive issue frequently is whether the lenders' ac-

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[425] *Id.* at 427.

[426] *Id.* at 426-27.

[427] *Id.* at 427.

[428] *Id.* at 428.

[429] *See also* First Nat'l Bank v. Langley, 314 So. 2d 324 (Miss. 1975)(en banc)(although action stemming from loss of customer's deposit founded on negligence, court imposed form of fiduciary obligation extending not only from bank to its customers, but also to customers' employees).

tions were privileged.[430]

A lenders' privilege argument was rejected by the Wyoming Supreme Court in *First Wyoming Bank v. Mudge*.[431] The Mudges sold their welding business to Redding.[432] The purchase agreement contained a nonencumbrance clause which prohibited Redding from mortgaging any of the purchased assets for more than the existing debt without the Mudges' consent.[433] Despite knowledge of the foregoing provision, the bank loaned Redding $100,000 secured by assets of the welding business.[434]

When Redding defaulted, the bank foreclosed on the assets. The Mudges obtained a $100,000 letter of credit to secure a release of the bank's lien. Later the bank drew down the full amount of the letter of credit.[435]

The Mudges successfully sued the bank for interference with their contractual relationship with Redding.[436] The court rejected the bank's privilege argument because the bank acted in bad faith.[437]

The opposite conclusion was reached in *Ford v. C.E. Wilson & Co.*[438] In *Ford*, the plaintiff asserted that the pledge of roses as collateral for a bank loan and the assignment of the account receivables had rendered it impossible for the purchaser, Wilson, to pay for the shipment, thereby inducing Wilson to break its contractual obligations with the plaintiff.[439] As to the claim of interference, the court equated the plaintiff's allegations to a claim that "a creditor who takes security under circumstances rendering payment of the claims of other creditors unlikely is liable in tort."[440] The court rejected such an argument. The

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[430] *See supra* note 240 and accompanying text (discussion of privileges available to lenders).

[431] 748 P.2d 713 (Wyo. 1988).

[432] *Id.* at 714.

[433] *Id.* at 714-15.

[434] *Id.* at 715.

[435] *Id.*

[436] *Id.* The Mudges recovered the face amount of the letter of credit, its purchase cost and interest. *Id.*

[437] *Id.* at 716-17.

[438] *Ford*, 129 F.2d at 614; *see supra* notes 390-397 and accompanying text.

[439] *Ford*, 129 F.2d at 616.

[440] *Id.* at 617.

court considered it reasonable for the bank to require collateral as a condition to a loan, noting that Wilson had the opportunity to accept or reject such requirements. The court determined that the bank had given valuable consideration for the security, and therefore "had a privilege to interfere with the plaintiff's contracts and expectancies because it was 'acting under an equal or superior right' when seeking security for its own advances."[441]

III. Conclusion

As noted throughout this article, the authors are of the opinion that Mississippi courts should reject lender liability theories which restrict the lenders' ability to enforce the terms of their loan agreements. Lenders include in these agreements provisions designed to minimize their losses if a loan goes sour. Borrowers recognize the purpose of these provisions when they sign the loan agreement. Other creditors of the borrower are free to impose similar conditions or to refuse credit. Restricting the enforceability of these provisions undermines the risk allocation understood by all parties at the initiation of their credit arrangement and impinges on the lender's right to protect its own economic interests. Absent fraud or other illegality, lenders should be permitted to rely on their contractual rights in extending and collecting their loans.

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[441] *Id.* at 617. *But see* Melamed v. Lake County Nat'l Bank, 727 F.2d 1399, 1404 (6th Cir. 1984)(court ruled that lender's memorandum setting forth plan to " 'help salvage whatever possible' " from debtor situation could be interpreted as improper interference, and evidence was sufficient to take claim to jury); Irwin & Leighton, Inc. v. W.M. Anderson Co., 532 A.2d 983, 993 (Del. Ch. 1987)(factual dispute existed as to Fidelity's participation in subcontractor/debtor's decision to repudiate contract with prime contractor).

THE IMPACT OF THE *TRANSCO* DECISION ON STATE REGULATION OF THE NATURAL GAS INDUSTRY*

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I. Introduction

Over the past several years, the natural gas industry has faced a crisis of unprecedented proportions. In the decade prior to 1982 there was a significant shortage of this valuable, clean burning fuel. Subsequently, there was a complete reversal of supply and demand, resulting in the current drastic oversupply. This oversupply was caused both by aggressive production practices as well as reduction in demand. These demand reductions have been the result of conservation measures, imports, mild weather, dramatic decreases in the price of alternate fuels, and federal energy policies. As a result of this oversupply, the fair market value of newly discovered natural gas has dropped dramatically from its highest levels prior to 1982.

The current crisis has had a significant impact on each segment of the natural gas industry. Natural gas pipeline companies, which have historically purchased gas at the wellhead for resale to industrial customers and distribution companies, have

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* A brief overview of this article was published recently in Natural Resources & Environment. *See* Grower, Montjoy, *State Regulation of Natural Gas After Transco*, 2 A.B.A. Sec. Nat. Resources L. 15 (Spring 1987). The article in its current form provides a substantive analysis of the *Transco* decision and its impact on state regulation of natural gas. The *Mississippi Law Journal* wishes to thank the Section of Natural Resources Law of the American Bar Association for their cooperation in the publishing of this article.

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found themselves with pre-1982 contracts to purchase significantly more gas at significantly higher prices than their markets will consume. Consequently, these pipelines were forced to curtail their purchases of gas from producers under their pre-1982 high cost contracts. Producers who drilled wells based upon these high prices and purchase levels found themselves unable to sell more than a trickle of gas. Federal energy policy has also reacted, attempting to completely restructure the natural gas industry in order to create a spot market for natural gas and to force natural gas pipeline companies, which historically have been marketers of gas, to instead open their pipelines to transport that gas for the benefit of others. Obviously, consumers who had the ability to make use of alternate fuels or natural gas from alternate sources have greatly benefited from the recent upheavals. On the other hand, consumers without the ability to switch fuel sources have found themselves saddled with ever higher prices for natural gas despite the market glut.

The recent market upheaval has also had an effect on the conservation commission of each gas producing state. The states have an historic and proper interest in the prevention of waste and the protection of correlative rights.[1] This task has been

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[1] *See* 1 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW § 204.6 (1985)(defining concepts of waste, correlative rights; tracing history of judicial intervention; outlining early attempts by representative states to protect rights, prevent waste).

In Mississippi, for example, this authority is vested in the State Oil and Gas Board. MISS. CODE ANN. § 53-1-1 *et seq.* (1972). Section 53-1-1 states the policy of the Board as follows:

> § 53-1-1 Declaration of policy.
>
> It is hereby declared to be in the public interests to foster, encourage and promote the utilization of the natural resources of oil and gas in the State of Mississippi *and to protect the public and private interests against the evils of waste in the production and utilization of oil and gas*, by prohibiting waste as herein defined; *to safeguard, protect and enforce the co-equal and correlative rights of owners in a common source* or pool of oil and gas to the end that each owner in a common pool or source of supply of oil and gas may obtain his just and equitable share of production therefrom; and to obtain, as soon as practicable, consistent with the prohibition of waste, the full development of progressive drilling of other wells in all producing pools of oil and gas or of all pools which may hereafter be brought into production of such, within the state, until such pool is fully defined.
>
> It is not the intent nor the purpose of this law to require or permit the proration or distribution of the production of oil and gas among the fields and

made much more difficult by the current market dislocations. Those producers connected to pipeline purchasers unable to take their gas have seen their wells' production reduced to a trickle. On the other hand, producers who have been willing and able to sell their gas on the spot market or who contracted for sales at prices low enough to be marketable under today's environment have produced significantly greater quantities of gas. Such disparities in production, particularly from wells draining from common pools, create potential problems of waste and the abuse of correlative rights. The approach to this problem most acceptable to producers and the states, the state ratable take rule, was held unconstitutional in *Transcontinental Gas Pipe Line Corp. v. State Oil & Gas Board* (hereinafter *Transco*).[2] The purpose of this paper is to examine alternate approaches to prevent waste and to protect correlative rights in light of *Transco*.

> pools of Mississippi, on the basis of market demand. It is the intent and purpose of this law to permit each and every oil and gas pool in Mississippi to be produced up to its maximum efficient rate of production, *subject to the prohibition of waste as herein defined, and subject further to the enforcement and protection of the co-equal and correlative rights of the owners of a common source* of oil and gas, so that each common owner may obtain his just and equitable share of production therefrom.

Id. (emphasis added). Most other states make similar provisions regarding their regulatory authority. However, as more fully discussed hereinafter, not all states have a legislative policy against the proration of production based upon market demand.

See WILLIAMS & MEYERS, MANUAL OF OIL AND GAS TERMS 955-57 (6th ed. 1984)(defining, describing waste both economic, physical)[hereinafter cited as MANUAL OF OIL AND GAS TERMS].

The correlative rights concept has been described as "a simple doctrine that owners of rights in a common source of supply may not inflict loss upon one another by conduct which is considered to be socially undesirable." Kuntz, *Correlative Rights in Oil and Gas*, 30 MISS. L.J. 1, 8 (1958). *See also* Manual of Oil and Gas Terms, *supra*, at 178-79 (defining correlative rights and outlining two aspects of doctrine: "(1) . . . each person has a right to produce oil [or gas] from his well, and (2) a right of the land owner to be protected against damage to a common source of supply and a right to a fair and equitable share of the source of supply").

See also, e.g. MISS. CODE ANN. § 53-1-17 (Supp. 1986)(vesting authority in Board to protect rights, prevent waste; defining duties of Board); §§ 53-3-3 (1972) (making waste, as defined in §§ 53-1-3, unlawful); *id.* at 53-3-5 (1972) (authorizing Board to regulate drilling and production so as to prevent waste, protect correlative rights); *id.* at 53-3-7 (Supp. 1986)(authorizing Board to require integration of interests to prevent waste); *id.* at 53-3-103 (Supp. 1986)(authorizing Board to require unit operation to prevent waste, protect correlative rights).

[2] 106 S. Ct. 709 (1986).

II. Background: An Historical Perspective of the Natural Gas Industry and the Effects of Its Regulation

A. The Early Years

Although the value of natural gas as a fuel was recognized very early,[3] it was unavailable to the nation at large because there was no transportation system.[4] Thus, for the early gas discoveries in Texas and Oklahoma, there was no market for these vast reserves of natural gas.[5] Therefore, a gas well was as welcome as a dry hole.[6]

The transportation problem, however, was eventually rectified. With the advent of seamless steel pipe, the interstate pipeline networks were constructed in the thirties, forties and fifties, connecting the producing areas with the highly populated consumer areas located principally in the north and east.[7] Addition-

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[3] *See* A. Leeston, J. Crickton & J. Jacobs, The Dynamic Natural Gas Industry, 3-12 (1963)(tracing history of natural gas use, production). In fact, it is interesting to note that although the Japanese had gas wells as early as 615 B.C., the Chinese made use of the fuel even earlier than that, transporting the gas via bamboo pipes from two-thousand-feet salt wells to the point of consumption. *Id.* at 3 (citing C. Engler & H. v. Hofer, Das Erdol seine Physik, Chemie, Geologie, Technologie and sein Wirtschaffsbetriel, IV, 234).

In Mississippi, the first commercial gas well was completed in 1926 in Monroe County. *Id.* at 41.

[4] *See* Leeston, Crickton & Jacobs, *supra* note 3, at 5-12 (tracing history of pipeline production).

[5] *Id*; *see also* J. McKie, The Regulation of Natural Gas 11 (1957)(noting absence of transportation means from Southwestern gas fields to consumption areas).

[6] Obviously, then, "[i]t was not until many centuries after its use by the Chinese people that natural gas became a primary source of energy." Leeston, Crickton & Jacobs, *supra* note 3, at 4. The tragedy herein was the fact that "[i]t was not until the 1920's that oil producers generally realized that natural gas was the *motive* force that lifts . . . the oil to the surface . . . ." *Id.* at 6. "Thus, the history of the miraculous fuel was one of appalling waste for many decades; for, while small fractions of natural gas were utilized here and there, enormous volumes of it were simply blown into the air." *Id.* at 5.

Today, a "dryhole" is defined as a "completed well which is not productive of oil and/or gas (or which is not productive . . . in paying quantities)." 8 H. Williams & C. Meyers, Oil and Gas Law § 255 (1985).

[7] Leeston, Crickton & Jacobs, *supra* note 3, at 5-12, 58-60 (tracing history of pipeline production techniques; noting importance of pipeline transportation); (citing Luty, *Development of Pipe Manufacture*, Oil & Gas J. vol. XXIX, No. 3, 58-60 (June 6, 1930); *see also* McKie, *supra* note 5, at 11-13 (noting effects of pipelines on natural gas sales in 1920s, 1930s).

ally, local distribution systems were built and expanded and many industries converted from oil and coal to natural gas because the fuel was both cheap and efficient.[8] Thus, natural gas pipelines became the connection between producers and the growing market.

B. The Advent of Federal Regulation: A Growing Supply

Historically, interstate pipelines have supplied the markets for natural gas by purchasing gas from the producers and delivering it to distribution companies for sale to ultimate consumers or to large industrial users. In other words, pipelines served as gas merchants, taking title to gas, transporting and reselling it, instead of merely transporting gas owned by others. The pipelines' resales to distribution companies were first subjected to public utility type governmental regulation[9] with the passage of the Natural Gas Act[10] (NGA) in 1938. Specifically, rates charged by pipelines to distribution companies had to receive governmental approval. The components of these approved rates include reimbursement of the prudently incurred cost of service, a fair rate of return on capital investment and a recovery of debt cost.[11] The purchase cost of natural gas is a part of the cost of

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[8] McKie, *supra* note 5, at 2-4 (noting gas is premium fuel in most instances).

[9] *See generally* 18 C.F.R. § 1 *et seq.* (1986)(current regulatory scheme as to all power, water resources administered by Federal Energy Regulatory Commission).

[10] *Natural Gas Act*, 15 U.S.C. § 717-717w (1982)(current regulation of natural gas companies engaged in interstate commerce)[hereinafter cited as NGA]. *See infra* note 13.

[11] These factors are weighed by the FERC in its rate-fixing function, *e.g.*, Federal Power Comm'n v. Memphis Light & Water Div., 411 U.S. 458, 460 (1973); Federal Power Comm'n v. United Gas Pipeline Co., 386 U.S. 237, 243 (1967) *rev'd on other grounds*, 393 U.S. 71; Chicago v. Federal Power Comm'n, 385 F.2d 629, 632-33 (1967), *cert. denied*, 390 U.S. 945. Cost of services includes operating costs, depreciation and federal income taxes. *Federal Power Comm'n*, 411 U.S. at 460. Return to the company is calculated by providing a fair amount of return based on the amount invested in the utility property. *Id.*

Other factors which bear on determination of a just and reasonable rate include depreciation and depletion of capital assets, *e.g.*, Colorado Interstate Gas Co. v. Federal Power Comm'n, 142 F.2d 943, 959-60 (10th Cir. 1944), *aff'd in part and rev'd in part on other grounds*, 324 U.S. 626, *aff'd on other grounds*, 324 U.S. 581, *reh'g denied*, 325 U.S. 891 (1945), *e.g.*, extraction revenues and costs, Panhandle Eastern Pipe Line Co. v. Federal Power Comm'n, 324 U.S. 635, 648-49 (1945), *reh'g denied*, 325 U.S. 892; Detroit v. Federal Power Comm'n, 230 F.2d 810, 819-21 (1955), *cert. denied*, 352 U.S. 829, *reh'g*

service and flows directly to the consumer.[12] Thus the pipeline's profit on regulated sales has never directly depended on its cost of gas. Rather, the pipelines "profit" is a reasonable rate of return allowed to be earned on its capital investment — one sufficient to provide the service and not amount to a confiscation of the utilities' property, yet low enough to maintain the lowest reasonable consumer price.[13]

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denied, 352 U.S. 919; Cities Service Gas Co. v. Federal Power Comm'n, 155 F.2d 694, 703 (10th Cir. 1946), *cert. denied*, 329 U.S. 773, *reh'g denied*, 329 U.S. 382 (1946), *e.g.*, taxes, *United Gas Pipe Line Co.*, 386 U.S. at 243 (1967); Distrigas of Massachusetts Corp. v. Federal Energy Regulatory Comm'n, 737 F.2d 1208, 1212 (1st Cir. 1984), *e.g.*, interests of investors, Federal Power Comm'n v. Texaco, Inc., 417 U.S. 380, 388-89 (1974); Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944), *e.g.*, interests of company's customers and shippers, Montana-Dakota Utilities Co. v. Federal Power Comm'n, 169 F.2d 392, 400-03 (8th Cir. 1948), *e.g.*, interests of consumers, *Hope Natural Gas Co.*, 320 U.S. at 605. *e.g.*, profits of similar businesses, Skelly Oil Co. v. Federal Power Comm'n, 375 F.2d 631 (10th Cir. 1967), *aff'd in part and rev'd in part*, 390 U.S. 747, *reh'g denied*, 392 U.S. 917, *e.g.*, promotion of exploration and development, Mobile Oil Co. v. Federal Power Comm'n, 417 U.S. 283, 318-19 (1974), *e.g.*, representative costs in area, Southern Louisiana Area Rate Cases (1968) 428 F.2d 407, 424-25 (5th Cir. 1970), *cert. denied* 400 U.S. 950 (1970), *e.g.*, and impact of rate upon industry, Southern Louisiana Area Rate Cases, 428 F.2d 407, 407 (5th Cir. 1970).

[12] *See supra* note 11.

[13] This regulatory scheme established by the NGA of 1938 and given life in subsequent administrative regulations comports with the express intent of Congress that the public interest be protected:

> . . .[I]t is hereby declared that the business of transporting and selling natural gas for ultimate distribution to the public is affected with a public interest, and that Federal regulation in matters relating to the transportation of natural gas and the sale thereof in interstate and foreign commerce is necessary in the public interest.

15 U.S.C. § 717(a) (1982).

The Federal Energy Regulatory Commission [hereinafter cited as FERC] and the courts which review appeals therefrom, is thus guided in this purpose with the "just and reasonable rate" standard:

> All rates and charges made, demanded, or received by any natural-gas company for or in connection with the transportation or sale of natural gas subject to the jurisdiction of the Commission, and all rules and regulations affecting or pertaining to such rates or charges, shall be just and reasonable, and *any such rate or charge that is not just and reasonable is declared to be unlawful.* (emphasis added).

15 U.S.C. § 717c(a) (1982).

The United States Supreme Court has variously rephrased and expanded upon the stated congressional purpose, to-wit: to protect consumers from exploitation, *e.g.*, Illinois Natural Gas Co. v. Central Illinois Pub. Ser. Co., 314 U.S. 498, 506 (1942), *e.g.*, to afford consumers complete, permanent and effective bond of protection from excessive rates and charges, Federal Power Comm'n v. Tennessee Gas Transmission Co., 371 U.S. 145,

We have just detailed how the price of gas at the point of sale between the pipeline and the distribution company is now and has been federally regulated since passage of the NGA in 1938. However, until 1954, the price paid by the pipeline to purchase the gas from producers was not regulated. In 1954, the United States Supreme Court issued a landmark decision, *Phillips Petroleum Co. v. Wisconsin*,[14] which determined that the Federal Power Commission (predecessor of the Federal Energy Regulatory Commission and hereinafter cited as FPC) had jurisdiction to regulate prices at the wellhead for gas sold in interstate commerce by producers.[15] The FPC did not, however, begin immediately exercising its price jurisdiction in 1954.[16] Rather, the FPC allowed wellhead price increases to go into ef-

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154 (1962), *e.g.*, and to assure adequate and reliable supply of gas at reasonable prices, California v. Southland Royalty Co., 436 U.S. 519, 523 (1978).

[14] 347 U.S. 672 (1954).

[15] *Id.* at 685. Phillips Petroleum Company was engaged in the production, gathering, processing and sale of natural gas. *Id.* at 674. It did not engage in the interstate transmission of gas from field to market nor was it affiliated with any interstate pipeline company. *Id.* at 675. However, Phillips did sell natural gas to several interstate pipeline transmission companies which, in turn, distributed the gas to consuming markets in fourteen states. *Id.* Phillips contended that it was not a natural gas company within the meaning of the NGA of 1938. *Id.* at 676. Phillips further argued that the sales it made were part of the "production and gathering" function to which the FPC's jurisdiction did not extend. *Id.* at 677.

The Court rejected this position. *Id.* In so doing, it relied on a statutory construction of 15 U.S.C. § 717(1)(b) which declared that Phillips "production and gathering" ended prior to the sales which brought it within the FPC's penumbrum. *Id.* at 678. The Court noted the consistency of this view with its prior decisions, citing, among others, Federal Power Comm'n v. Panhandle E. Pipeline Co., 337 U.S. 498, 505 (1949); Colorado Interstate Gas Co. v. Federal Power Comm'n, 324 U.S. 581, 598 (1945); and, Interstate Natural Gas Co. v. Federal Power Comm'n, 331 U.S. 682, 692-93 (1947). Finally, the majority noted that ". . . the legislative history indicates a congressional intent to give the commission jurisdiction over the rates of all wholesales of natural gas in interstate commerce, whether by a pipeline company or not and whether occurring before, during, or after transmission by an interstate pipeline company." *Phillips*, 347 U.S. at 682 (footnote omitted).

[16] Apparently, the FPC simply did not have enough personnel to regulate all producers. *See* J. LANDIS, REPORT ON REGULATORY AGENCIES TO THE PRESIDENT-ELECT 54 (printed for the use of the Senate Committee on the Judiciary, 86th Cong., 2d Sess. 1960)(detailing breakdown in administrative process). The personnel problem was the result of the commission's attempt to apply the same regulatory technique it had always used — calculation of just and reasonable rates for each company. *See* Public Ser. Comm'n v. Mid-Louisiana Gas Co., 463 U.S. 319, 328-29 (1983)(noting impracticality of administration).

fect pending establishment of just and reasonable rates. However, in *Atlantic Refining Co. v. Public Service Commission of New York*[17] [hereinafter *CATCO*], the Supreme Court held that the FPC could not continue to permit escalations pending establishment of just and reasonable rates but had to hold interim prices "in line" with previous levels.[18] The Commission's immediate response was a conservative "in line" pricing policy which, in concert with other restrictive guidelines, held gas prices at a low level.[19]

C. *After Phillips and CATCO: The FPC Responds*

Beginning in 1960, the FPC established regional guideline prices pending the establishment of just and reasonable rates and instituted the major "area rate" proceedings to set such rates.[20] The rates established in the area rate proceedings were

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[17] 360 U.S. 378 (1959).

[18] *Id.* at 394. In this case, four independent producers petitioned the FPC for authorization to sell natural gas obtained from offshore fields to an interstate transmission company. *Id.* at 380-81. The producers sought initially higher-than-usual rates coupled with escalator clauses calling for periodic increases in specific amounts. *Id.* at 383. The Commission having twice refused to issue the requested certificate of convenience and necessity due to insufficient evidence justifying the higher rates, the producers finally threatened to withhold the gas from the market. *Id.* at 386. Upon rehearing, the Commission thereupon issued the requested order, including the objectionable rate stipulations, based upon "the primary consideration that the public . . . is greatly in need of increased supplies of natural gas." *Id.*

Upon subsequent review, the Third Circuit remanded, holding that the Commission was without jurisdiction to entertain the producers limited proposal. *Id.* at 387.

On writ of certiorari, the Supreme Court rejected the Third Circuit's view but, going further, found the Commission's order in error. *Id.* at 387-88, 394. Offering the Commission guidance in future proceedings on the matter, the Court focused on protection of the public interest. *Id.* at 388-94. In order to grant certificates of public convenience and necessity, the Court stated, proposed rates must be shown to be in the public interest. *Id.* at 388-91. Further, the Commission is empowered to impose such conditions as it believes necessary to further the public interest by, for example, "holding the line" pending the establishment of just and reasonable rates. *Id.* at 391-92.

[19] Federal Power Comm'n Statement of General Policy No. 61-1, 24 F.P.C. 818 (1960). The "in-line" pricing policy stated that the Commission would not approve new certificates for gas sales at higher than prevailing area rates. *Id.* The so-called "guideline" doctrine stated that the Commission would not approve, in advance, price increases above specified area ceilings. *Id.* The FPC seemingly equated the public interest with the lowest possible price.

[20] *See, e.g.*, Southern Louisiana Area Rate Cases, 40 F.P.C. 530 (1968), *aff'd*, 428 F.2d 407 (5th Cir. 1970), *cert. denied*, 400 U.S. 950 (1970); Permier Basin Area Rate

based on historical cost of production,[21] rather than the true value or the value of alternative fuels. Under this approach, the regulated wellhead price was based upon the allocated cost of producing and finding natural gas as though the producer were a public utility.[22] Unfortunately, this allocation process had as its basic premise that natural gas was merely a by-product of oil exploration and development. Moreover, the rates established were based upon the FPC's view that the public interest was best served by maintaining the lowest possible price to consumers.[23] The result was that the natural gas continued to be significantly underpriced as compared with other fossil fuels.[24]

In addition to pricing gas too low, the FPC also imposed excessive reserve requirements on pipelines. In the early 1950s, a pipeline had to show a twenty year reserve life in order to secure FPC approval of service to a new market.[25] In other words, pipelines had to show that currently committed reserves were adequate to serve not only its current market, but also the projected new market, for a period of twenty years. In 1959 this require-

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Cases, 34 F.P.C. 159 (1965), *aff'd in part and rev'd in part sub nom.*, Skelly Oil Co. v. Federal Power Comm'n, 375 F.2d 6 (10th Cir. 1967), *aff'd in full*, 390 U.S. 747 (1968).

[21] *See* Southern Louisiana Area Rate Cases, 428 F.2d 407, 418-21 (5th Cir. 1970)(following *Permian* cost approach, summarizing southern Louisiana area costs); Skelly Oil Co. v. Federal Power Comm'n, 375 F.2d 6, 24-26 (10th Cir. 1967)(quoting FPC's position that "costs must be major factor in determining area price"; reviewing Permian Basin area costs).

[22] *See* Ringlab, *Natural Gas Producer Price Regulation Under the NGPA: Regulatory Failure, Alternatives, and Reform*, 20 HOUS. L. REV. 709, 715 (1983).

In addition to considering historical costs, the area rate policy established a two-tiered pricing structure: a "new gas" rate for gas produced independently of oil from wells drilled after a specified date, and an "old gas" rate for all other gas. Public Ser. Comm'n v. Mid-Louisiana Gas Co., 463 U.S. 319, 329 (1983). This vintaging concept relied on the premise that for gas already in production "price could not serve as an incentive, and . . . any price above average historical costs, plus an appropriate return, would merely confer windfalls." *Id.* (quoting Permian Basin Area Rate Cases, 390 U.S. 747, 797 (1968)).

[23] *Mid-Louisiana Gas*, 463 U.S. at 329.

[24] *See* Comment, *Take or Pay Provisions: Major Problems for the Natural Gas Industry*, 18 ST. MARY'S L.J. 251, 257 (1986)(noting effect of area-rate method on natural gas prices).

[25] *See, e.g.*, Northern Natural Gas Co., 11 F.P.C. 174, 189 (1952)(burden on pipeline to show amount of reserve); Texas Illinois Natural Gas Pipeline Co., 9 F.P.C. 105, 113-46 (1950)(same); Transcontinental Gas Pipeline Co., 9 F.P.C. 32, 38 (1950)(same).

ment was reduced to twelve years,[26] but it was still too long. As a result of this reserve requirement and the fact that gas markets were slower to develop than were producer connections to pipelines, there was an oversupply of natural gas in the early 1960s.

D. The States React

The typical response of states in the sixties to this oversupply was the use of market demand nominations[27] to establish well allowables.[28] Pipeline companies would notify the state regulatory agencies of the quantities of gas that they expected to take during certain periods to satisfy their markets and the wells were then allowed to produce only their pro rata share of that market demand.[29] In this way the smaller market demand was equitably distributed among a group of producers so that each producer was able to receive his fair share of the market and drainage problems were minimized. The state was thus able to prevent waste and protect the correlative rights of its mineral owners.[30]

E. From Frustration to Desperation: Plunging into the 1970s Shortage

The oversupply situation of the early sixties did not remain with us forever, for the continuing increase in interstate market demand eventually equaled and then surpassed available supplies.[31] This led to severe shortages of natural gas and curtail-

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[26] *See, e.g.*, Trunkline Gas Co., 21 F.P.C. 704, 708-09 (1959)(amount of reserve required for FPC approval reduced to 12 years); Midwestern Gas Transmission Co., 21 F.P.C. 653, 656-57 (1959)(same).

[27] *See* Choctaw Gas Co. v. Corporation Comm'n, 295 P.2d 800, 802 (Okla. 1956)(defining nominations in gas production context); *see also* MANUAL OF OIL AND GAS TERMS, *supra* note 1, at 546 (same).

[28] *See* MANUAL OF OIL AND GAS TERMS, *supra* note 1, at 35-37 (defining well allowables).

[29] *See* Choctaw Gas Co., 295 P.2d at 802 (Okla. 1956)(challenge to Oklahoma's established well allowables).

[30] *See supra* note 1 and accompanying text.

[31] FPC Staff Report No. 2, National Gas Supply and Demand 1974-1990 (1972) stated:

> The emergence of a natural gas shortage during the past two years marks a historic turning point — the end of natural gas industry growth uninhibited

ments in the early seventies. The factors which led from an oversupply to a tremendous shortage within ten years are numerous, but may be condensed into a few major points.

First, in the early sixties there was a widespread belief that there was an almost inexhaustible supply of natural gas available for the country, and that demand for natural gas would continue to grow slowly: this belief naturally discouraged exploration.

Second, the FPC continued to keep the regulated prices of natural gas at an unrealistically low level.[32] This low price had two consequences — it spurred new demand for gas and it discouraged exploration for new reserves;[33] especially exploration

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> by supply considerations. Not only has the Nation's proven gas reserve inventory for the lower 48 states been shrinking for the past three years, but major pipeline companies and distributors in most parts of the country have been forced to refuse requests for additional gas service from large industrial customers and from many new customers. For practical short-term purposes we are confronted with the fact that current proven reserves in the lower 48 states, as reported by the American Gas Association, have dropped from 289.3 trillion cubic feet in 1967 to 259.6 in 1970, a 10.3 percent drop within a three-year period. Furthermore, approximately 95 percent of this proven reserve inventory is already committed to gas sales contracts and is therefore unavailable for sales to new customers or for increased volumes to old customers.

Id. at xi (quoted in FPC v. Louisiana Power & Light Co., 406 U.S. 621, 626 n.2 (1972); *see also* Breyer & MacAvoy, *The Natural Gas Shortage and the Regulation of Natural Gas Producers*, 86 HARV. L. REV. 941, 965-79 (1973)(detailing causes of shortages).

[32] *See supra* notes 19-24 and accompanying text. The continued low prices were a function of the FPC's regional pricing scheme which utilized oft-inaccurate historical cost data rather than recent production costs. Comment, *supra* note 24 at 257; *see also* Pierce, *Natural Gas Regulation, Deregulation and Contracts*, 68 VA. L. REV. 63, 67 (1982)(historical costs standard applied in area rate proceedings). Later, the FPC took a step in the right direction when it first considered future costs projections as a part of its decision to abandon establishment of area rate in favor of fixing a national rate. FPC Opinion No. 699, 51 F.P.C. 2212 (1974) *modified*, Opinion No. 699-H, 52 F.P.C. 1604 *aff'd*, Shell Oil Co. v. FPC, 520 F.2d 1061, 1066-69 (5th Cir. 1975), *cert. denied*, 426 U.S. 941 (1976). Consequently, prices rose gradually but, on the whole, remained inequitably low. *See* Mid-Louisiana Gas Co. v. FERC, 664 F.2d 530, 533 (5th Cir. 1982)(noting markedly low rates as established by Commission), *vacated*, 463 U.S. 319 (1983). As a part of this new approach the Commission also temporarily abandoned to the vintaging practice. *National Rates for Natural Gas*, 52 F.P.C. 1604, 1636 (1974)(Opinion No. 699-H). *See supra* note 22 and accompanying text. The Commission resumed vintaging in 1976. *National Rates for Natural Gas*, 56 F.P.C. 509 (1976)(Opinion No. 770).

[33] *See* Mid-Louisiana Gas Co. v. Fed. Energy Reg. Comm., 664 F.2d 530 (5th Cir. 1981) (noting lack of incentive in rates to encourage exploration).

for deep, high-cost gas.[34]

A third factor contributing to the shortage was the development of a significant intrastate market in the states with large gas reserves.[35] The price controls imposed as a result of the *Phillips* decision in 1954 applied only to gas sold in interstate commerce.[36] Therefore, gas sold in intrastate commerce could be sold at its true fuel value and adjusted to market demand.[37] Since the true value of gas was much higher than the unrealistically low price allowed by the federal government, the price of gas sold intrastate was somewhat higher.[38] Wherever possible,

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[34] This market anomaly is illustrated by a lawsuit tried by one of the authors several years ago involving the Waveland Gas Field in South Mississippi, Crosby v. Texas Pacific Oil Co (unreported). Therein, major mineral interest owners sued a lessee for drainage and for failure to develop the lease. Only two producing wells had been drilled in the field in the approximately ten years since its discovery in 1965. The production unit for one of the wells included a small portion of the plaintiff's large lease. The lawsuit proceeded after higher prices made feasible the drilling of more producing wells provided that a substantial portion of plaintiffs' undeveloped lands were productive. The defense relied on the theory that, despite the gas shortage, federal ceiling prices were so low prior to 1975 as to render development uneconomic. The trial court agreed, finding that the lessee had not been obligated to drill new wells, even in a proven field, where the sale price for the gas was too low to justify the costs and risks involved. The point becomes more dramatic when one learns that 25 additional wells were drilled in this same field after gas prices increased. The order and opinion of the lower court in *Crosby* was not appealed from the Chancery Court of Hancock County, Mississippi. Clearly, federal price regulations had a chilling effect on the exploration for new reserves in this and other areas.

[35] Breyer & MacAvoy, *supra* note 31, at 979. In the Permian Basin area of Texas, for example, sales to interstate pipelines in 1966 accounted for 80% of production from new reserves. In the first half of 1970, sales to interstate pipelines accounted for only 9 percent. *Id.* (citing *Hearings on Natural Gas Policy Issues Before the Senate Comm. on Interior & Insular Affairs*, 92d Cong. 2d Sess., pt. 1, at 295, 298 (1972)(statement of J.C. Swindler, Chairman, N.Y. Public Service Comm'n)).

[36] Gas produced in, for example, Texas and sold within the state of Texas remained completely free from federal wellhead price controls. Large, long-lasting gas supplies at competing prices lured many industries to Texas and justified further exploration by producers. Breyer & MacAvoy, *supra* note 31, at 979.

[37] *Id.* at 979. "Prices offered by interstate buyers for the new gas in this area rose from 17 cents per Mcf in 1966 to 20.3 cents per Mcf in 1970, and toward the end of 1970, the intrastate pipelines bought more than 200 billion cubic feet of reserves at initial delivery prices of 26.5 cents per Mcf." *Id.* (citing Reply submittal of the Office of Economics, Federal Power Comm'n, Initial Rates for Future Sales of Natural Gas for All Areas, Docket No. 12-389A, at 12, 19 (Oct. 1970)).

[38] *Id.* While intrastate prices rose, interstate pipelines were so regulated as to hold their prices from 16 to 17 cents per Mcf. *Id.* "The inescapable conclusion is that the interstate pipelines were simply outbid." *Id.*

producers would, of course, divert their sales of gas from the interstate to the intrastate market in order to recognize a higher price and to avoid red tape.[39] Naturally, this trend resulted in a significant decrease in the supplies of gas which were available for the interstate market during the sixties and seventies.

Although the above are the primary factors of the shortage, there are other significant factors. In the late 1960s, pollution requirements became more stringent,[40] encouraging industries to switch to natural gas as a cleaner burning fuel. Additionally, as greater supplies of natural gas were diverted to the intrastate market, many interstate pipelines were compelled to seek needed reserves from federal lands offshore, the gas from which could not be sold intrastate.[41] However, because offshore wells take much more time and effort to drill,[42] these reserves did not develop as quickly as needed, leaving an unfulfilled demand in the interstate market.

The result of all of these factors became apparent as early as 1970 and 1971 when certain pipelines' available supplies of

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[39] "The FPC's price levels for natural gas supplies are now generally acknowledged to have been inadequate to attract gas to the interstate market." FERC, *Staff Report on Pipeline Ratemaking* B-3 (Sept. 1982).

> [I]nterstate pipelines which absorbed 84 percent of production from new reserves in 1966, absorbed only nine percent in the first half of 1970. Prices for new gas offered by intrastate lines rose from 17.0 cents per Mcf in 1966 to 20.3 cents per Mcf in 1970. Toward the end of 1970, the intrastate pipelines bought more than 200 billion cubic feet of reserves at initial delivery prices of 26.5 cents per Mcf. During the same period, interstate prices remained between 16 and 17 cents per Mcf — near the regulatory ceiling. The interstate pipelines were simply outbid.

BREYER & MACAVOY, FEDERAL REGULATION BY THE FEDERAL POWER COMMISSION, (1974) (footnotes deleted).

[40] *E.g.* National Environmental Policy Act of 1969, 83 Stat. 852, 42 U.S.C. §§ 4321-47 (1969)(pollution control); *see also* S. REP. No. 91-296, 91st Cong., 1st Sess. (July 9, 1969)(same); H.R. REP. No. 91-378, 91st Cong., 1st Sess. (Dec. 1969)(same). *See generally* G. GARVEY, ENERGY, ECOLOGY, ECONOMY, 93-111 (1972)(discussing ecological impact of petroleum production).

[41] Because these federal leases are located outside state borders, all gas produced therefrom must cross state lines to be sold. Therefore, such gas is committed to the interstate market. Continental Oil Co. v. FPC, 370 F.2d 56, 66 (5th Cir. 1966), *cert. denied*, 388 U.S. 910 (discussion of federal leases).

[42] *See generally*, P. SWAN, OCEAN OIL AND GAS DRILLING AND THE LAW (1979)(discussing exploration, development problems unique to offshore oil and gas production).

natural gas were insufficient to meet peak demands.[43] The problem was compounded by the Arab oil embargo in 1973.[44] This embargo removed from the market much of the imported oil upon which America had become dependent.[45] Many consumers therefore attempted to switch from fuel oil to natural gas, thus further increasing demand. Industrial development was severely reduced in some parts of the country because pipelines and distribution companies could not supply new customers.

F. The Federal Response to the Shortage: Curtailments, Price Increases and the NGPA

In response to the shortage situation, the FPC approved curtailment plans by the pipelines.[46] All of these plans recognized that the average residential consumer did not have the ability to switch to alternate fuel for heating their homes while large industrial consumers did have alternate fuel capabilities.[47] Thus, the curtailment plans invariably contained priorities which required pipelines to withdraw supplies of natural gas from electrical power plants and other large industrial consumers to the extent necessary to maintain an adequate supply of gas to residential consumers.[48] This situation led to massive litigation by electrical utility and industrial boiler fuel consumers

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[43] *See supra* note 31 and accompanying text. *See also* FEDERAL POWER COMMISSION, BUREAU OF NATURAL GAS, NATURAL GAS SUPPLY AND DEMAND, 1971-1990, at 123 (1972)(noting demand exceeding supply by 3.6% in 1971; 5.1% in 1972; predicting 12.1% shortfall in 1975).

[44] *See generally* J. PAUST & A. BLAUSTEIN, THE ARAB OIL WEAPON (1977)(chronicling causes, effects of embargo on Western governments and societies).

[45] *Id.*

[46] The FPC, in April, 1971, established a general policy outlining steps to be taken by pipelines to ensure continuity of service during shortages. Order No. 431, 45 F.P.C. 570 (1971), *codified at* 18 C.F.R. § 2.70 (1975). This policy directed interstate pipelines to prepare for impending curtailments so as to ensure that adequate service to residential consumers would be maintained. 45 F.P.C. at 571-72; *see also* 49 F.P.C. 85 (1973)(curtailments defined); FPC v. Louisiana Power & Light Co., 406 U.S. 621 (1972)(discussing FPC jurisdiction over curtailment plans.

[47] 45 F.P.C. at 572. The FPC's statement of policy, recognizing this fact, had urged interstate pipeline companies to curtail amounts "equivalent to all interruptible sales" and "large boiler fuel sales where alternate fuels are available." *Id.*

[48] *Id.* Nevertheless, the combination of bitterly cold winters and gas shortages were blamed for several deaths.

against the pipelines because their compliance with these curtailment programs prevented them from honoring the gas sales contracts they had previously entered with these major consumers.[49]

Another federal response to the crisis of 1974-75 was to gradually increase the price of natural gas.[50] Although this encouraged some additional exploration, it did not do enough. The price increases simply were not enough to compete with intrastate markets or to provide an incentive to producers to explore for and produce significant quantities of deep high-cost gas into the interstate market.

In April, 1977, President Carter declared "the moral equivalent of war" on the energy crisis that had gripped the nation since 1973 and challenged Congress to pass a comprehensive national energy plan.[51] Congress subsequently passed the Natural Gas Policy Act of 1978 (NGPA)[52] which attempted to grant to producers the necessary incentives to drill for the deeper gas zones which could provide additional and substantial gas reserves. In general, the NGPA increased the prices of significant quantities of price-regulated gas[53] and included monthly escalations of these prices.[54] The NGPA also extended federal regulatory controls to the intrastate market, an area previously exempt from federal price controls, and effectively eliminated any advantage previously held by the intrastate market in the

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[49] *See, e.g.*, FPC v. Louisiana Power & Light Co., 406 U.S. 621 (1972)(litigation of basic contractual claims); North Carolina v. FERC, 584 F.2d 1003 (D.C. Cir. 1978)(same); Consolidated Edison Co. v. FPC, 512 F.2d 1332 (D.C. Cir. 1975)(same); American Smelting & Refining Co. v. FPC, 494 F.2d 925 (D.C. Cir.)(same); *cert. denied*, 419 U.S. 882 (1974); *see also* Note, *Contractual Liability of Pipelines for Damages caused by Gas Supply Curtailments*, 6 ENERGY L.J. 281 (1985).

[50] This use was a function of the new national rate pricing scheme of the FPC which, for the first time, considered future cost projections. *See supra* note 32 and accompanying text; *see also* Pierce, *supra* note 32, at 68 (noting price increase of early 1970's). Prices rose from $0.42 per MMBtu in 1972 to $1.42 per MMBtu in 1976. *Id.* at 68, n. 19. Also contributing to the price increase was a built-in one cent per Mcf annual escalator. National Rates for Natural Gas, ____ F.P.C. ____, 4 P.U.R. 4th 401 (1974)(Op. No. 699).

[51] 123 CONG. REC. 11482 (1977).

[52] 615 U.S.C. §§ 3301-3432 (1982).

[53] *See id.* at §§ 3311-3320 (establishing new ceiling prices for various categories of natural gas).

[54] *Id.* at §§ 3312(b), 3313(b), 3314(b), 3316, 3317, 3318 and 3319(b).

competition for gas supplies.[55] Gas discovered below 15,000 feet was price deregulated[56] so that it could be sold at much higher prices, thereby creating an inducement for drilling such wells.[57] Further, the NGPA provided that other categories of gas would become price-deregulated on January 1, 1985.[58] The federal government was still interested in providing gas at the lowest possible price to the ultimate consumer,[59] but recognized that higher prices were a necessary evil in order to encourage production of adequate supplies.[60]

G. The Market Reacts

Unfortunately, the price incentives under the NGPA and other factors came late during a severe shortage. In 1978, the world energy shortage appeared to be unending. With world oil prices consistently increasing, many expected natural gas prices to continue to escalate as well. This led to a general perception of tight supply and ever increasing gas prices.[61] After the adoption of the NGPA in 1978, substantial oil price increases and the expectation of high deregulated gas prices created the biggest boom the drilling industry has ever seen. New gas supplies were found and old reserves were further developed. Well deliverabilities were increased to their maximum.

As additional gas reserves became available, the interstate purchasers with severe shortages of reserves sought to increase their supply capabilities by committing these reserves to long-

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[55] *Id.* at § 3315.

[56] *Id.* at § 3317.

[57] *Id.*

[58] *Id.* at § 3331.

[59] *See, e.g. id.* at §§ 3314, 3316(a), and 3319 (provisions retaining NGA pricing standards as consumer protection measure); *see also*, Note, *Legislative History of the Natural Gas Policy Act: Title I*, 59 TEX. L. REV. 101, 119-20 (1980)(noting application of historical consumer protection under NGA to certain categories of natural gas).

[60] The FPC foreshadowed its tough political choice when it stated that "consumer protection embraces adequacy of supply as well as the lowest reasonable price . . . . The cost to consumer is just as real whether it takes the form of inadequate service or an excessive price." National Rates of Natural Gas, ___ F.P.C. ___, 15 P.U.R. 4th 21, 66 (1976)(Op. No. 770).

[61] *See* Maryland People's Council v. F.E.R.C., 761 F.2d 768, 771 (D.C. Cir. 1985)(then Circuit Judge Scalia remarked in understated dicta that "[these] 1978 predictions of the 1985 market were much in error.").

term contracts.[62] Because of the competition for these reserves, a sellers' market developed, with the producer able to demand and receive contracts which included significantly higher price and quantity terms for deregulated gas.[63] Additionally, many of these new contracts for the purchase of deregulated gas had alternate pricing mechanisms. One typical provision was tied to the price of No. 2 fuel oil[64] which then increased substantially in price due to deregulation. This resulted in a further substantial jump in the price of deregulated gas. Another typical mechanism was a "favored nations clause" which tied the price payable for gas to the average of several highest prices in a certain geographic area. Thus, price increases resulting from more expensive No. 2 fuel oil were translated, through the mechanism of favored nations clauses, into higher prices in other contracts. Unfortunately, purchase contracts followed the lead of Congress which, in enacting the NGPA, provided for automatic upward price escalations but made no provision for downward revisions. Thus, when fuel oil fell in price, gas prices did not make a corresponding correction. The net result was price increases which fueled the boom in drilling activity. Thus, after 1978, there was a significant increase in the price of deregulated gas. This was caused by the perception of a shortage for the foreseeable future, by increases in the prices of comparable fuels, by the auto-

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[62] By 1980, 67% of all gas purchase contracts had terms of 20 or more years. U.S. DEPT. OF ENERGY, NATURAL GAS PRODUCER/PURCHASER CONTRACTS AND THEIR POTENTIAL IMPACTS ON THE NATURAL GAS MARKET 62 (1982).

Pipeline purchasers had seen severe curtailments endanger supplies to schools, hospitals, and even some small commercial and residential users and endeavored to prevent such serious curtailment problems again. *See supra* notes 44-47 and accompanying text.

[63] From mid-1981 to December of the same year, natural gas prices rose at a 40% annual rate. Comment, *supra* note 24, at 258 n.39 (citing Turner, *Natural Gas — Impact of Deregulation or Regulation on Sales Contracts*, 29 ROCKY MTN. MIN. L. INST. 501, 510-11 (1983)). By the end of 1982, consumer gas prices were up to 24% higher than the previous year. H. Boadman and W. Montgomery, *Natural Gas Markets After Deregulation* 9 (1983)

[64] *See* MANUAL OF OIL AND GAS TERMS, *supra* note 1, at 229 (defining distillate fuel oils and including No. 2 fuel oil); *see also* Pierce, *Reconsidering the Roles of Regulation and Competition in the Natural Gas Industry*, 97 HARV. L. REV. 345 (1983) [hereinafter cited as *Reconsidering the Roles*](noting that 3.0% of interstate contracts for old gas contained indefinite escalation clauses tied to price of No. 2 fuel oil)(citing Decision Analysis Corporation, Analysis of Natural Gas Producer/Interstate Pipeline Contracts (1981)).

matic monthly escalations provided by the NGPA for regulated gas and by contracts for deregulated gas.[65]

However, at the same time other market factors were beginning to react. As energy prices began their upward spiral after the Arab oil embargo,[66] conservation measures began to take on an importance as never before.[67] Industries began reducing the use of fuel oil and gas. Some industries combined this reduction with a shift to cheaper fuels, such as coal.[68] Commercial and residential users generally began using less gas because of its high cost.[69] Congress even passed a law prohibiting the construction of new electric power plants fueled by natural gas.[70] Further, imported goods and an economic depression caused the slow-down or shutdown of many plants, resulting in further decreases in demand for natural gas.

Subsequently, because of the reduction in oil demand and consequent reaction to supply and demand market factors, oil prices began to drop to some extent. The result was that some fuel oil prices decreased, for the first time, below the cost of natural gas.[71] However, with built-in escalators,[72] the prices of regulated gas ratcheted forever upward.[73] Thus, there was simply no

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[65] *See supra* note 52 and accompanying text.

[66] *See supra* note 42 and accompanying text (noting effects of Arab oil embargo on Western nations).

[67] *See* Maryland People's Counsel v. F.E.R.C., 761 F.2d 768, 771 (D.C. Cir. 1985)(noting conservation measures as affecting gas supply); *see also* Comment, *supra* note 24, at 253-59 (noting decade of energy crisis created conservation-conscious consumers).

[68] *See* Adair & Bloom, *Flexible Pricing and Other Partial Solutions to the Problems Faced by Gas Distribution*, 4 ENERGY L.J. 239, 239 n.1 (1983)(noting ability of many industrial gas consumers to switch to cheaper fuels).

[69] Maryland People's Counsel, 761 F.2d at 771.

[70] 42 U.S.C. § 8311(1) (1986). The statute further provides that "no new electric powerplant may be constructed without the capability to use coal or any other alternate fuel as a primary energy source." *Id.* at § 3311(2). This law, aimed at conservation, has had and will continue to have far-reaching impact on natural gas demand.

[71] *See* Comment, *supra* note 24, at 259 (noting fall in oil prices, resultant demand shift from gas to oil); *see also* Wisconsin Gas Co. v. FERC, 770 F.2d 1144, 1151 (D.C. Cir. 1985)(noting declining oil prices' impact on natural gas demand); Maryland People's Counsel, 761 F.2d at 771 (lower costs of alternative fuels as decreasing gas demand); Gulf Oil Corp. v. Tenneco, Inc., 608 F. Supp. 1493, 1495 (E.D. La. 1985)(noting oil prices' impact on natural gas supply).

[72] *See supra* note 51 and accompanying text.

[73] *See* Wisconsin Gas Co., 770 F.2d at 1151 (natural gas prices rose, remained high

means for the purchase price of gas to react to the market.[74] Natural gas as a fuel became uncompetitive with other fuels, thereby further reducing demand.[75]

By 1982, the interstate pipeline purchasers, which had so vigorously pursued new supplies of gas in order to replenish their reserves after the curtailment years, found themselves faced with waning market demand.[76] This reduction in demand, coupled with increases in supply brought about by high prices, resulted in a tremendous oversupply of gas in the market place.

H. The Current Glut: Problems for Everyone

Despite the oversupply, the pipelines' fixed costs and contract obligations to purchase gas continued. Thus, fewer consumers were required to shoulder a larger share of these costs, with the result being higher prices. The industry was caught in a "death spiral", in which the cost of gas goes up, causing the market to shrink, which causes additional price increases, which causes an additional shrinkage of the market.[77]The manner in which federal price regulation and deregulation has been administered has exacerbated this problem.[78]

Although this resulted in problems for everyone, the problems of parties at either end of the spectrum were widely diverse. Consumers who could not switch to an alternate fuel (such as residential consumers) and the FERC, which keeps consumer interests in mind,[79] were opposed to high prices for natu-

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in time of high supply, low demand); *see also supra* note 60 and accompanying text (effect take or pay provisions had on natural gas industry).

[74] *See* Note, *Natural Gas Regulation and Market Disorder*, 18 TULSA L.J. 619, 637-38 (1983)(arguing that federal policy is primary reason for absence of relationship between price of natural gas, market).

[75] *See* Martin, *Brambles in the Gas Patch: Problems of Natural Gas Decontrol*, 33 MERCER L. REV. 751, 763-64 (1982)(noting disparity in fuel prices, consumer choice).

[76] Pipeline company natural gas sales fell by 12.3% from 1982 to 1983. Comment, *supra* note 24, at 258 n.39 (citing DEPARTMENT OF ENERGY/ENERGY INFORMATION ADMINISTRATION, NATURAL GAS MONTHLY 29 (Mar. 1984)).

[77] *See generally* Pierce, *Reconsidering the Roles*, *supra* note 64, at 345 (esoteric look at purely economic aspects of supply, demand in natural gas industry); Pierce, *supra* note 32, at 63 (same); Breyer & MacAvoy, *supra* note 31, at 941 (same).

[78] *See supra* notes 71-72 (noting absence of relationship between price, natural gas, market).

[79] *See supra* notes 13-56 and accompanying text (establishing that regulation of

ral gas, particularly in a time of surplus. On the other hand, producers with investments in wells and contracts to sell that gas demanded that their gas be purchased, despite the fact that the price and quantities exceeded what the market could bear.[80] The pipeline purchaser was in the middle. Pipelines were unable to take but a trickle of their contract requirements for higher cost gas supplies. As a result, they are exposed to billions of dollars of "take-or-pay" claims.[81]

The current problems have given rise to much litigation at both ends of the pipeline. At the FERC, many consumer groups have challenged pipeline resale rates.[82] The FERC itself has proposed complete restructuring of the natural gas industry.[83] On

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transportation, sale of natural gas is in public interest).

[80] *See* Martin, *supra* note 75, at 752-53 (noting absence of relationship between production cost, value of natural gas).

[81] A take-or-pay clause in a gas purchase contract generally requires the purchaser to either accept current delivery of gas available for sale and pay for it or, if it cannot accept delivery to nevertheless pay for the gas with the right to accept delivery at a later date, usually within five years. MANUAL OF OIL AND GAS TERMS, *supra* note 1, at 882; *see also* Pierce, *supra* note 32, at 78-79 (definition of take-or-pay clause).

In 1982, over 700 million dollars in take or pay costs were included in pipeline rates. Energy Information Administration, U.S. Dept. of Energy, *Structure and Trends in Natural Gas Well Head Contracts* 38 (1983). By December 1983, the figure had risen to over one billion dollars. Energy Information Administration U.S. Dept. of Energy, *Statistic of Interstate Natural Gas Pipeline Companies*, Table 20 (1983). By 1985, FERC was accepting industry estimates of seven billion dollars in take or pay obligations. Associated Gas Distrib. v. FERC, 824 F.2d 981, 1023 (D.C. Cir. 1987).

[82] *See, e.g.*, Maryland People's Counsel v. FERC, 761 F.2d 768 (D.C. Cir. 1985)(challenging FERC's approval of pipeline purchasers, producers' amendment of contracts to allow higher resale rates); *see also* Nowak & Leitch, *Maryland People's Counsel: Will it Spur Changes in FERC's Regulation of the Natural Gas Industry Cases*, 6 ENERGY L.J. 265, 268-72 (1985)(noting probable effects on regulation of natural gas; analyzing impact of case in light of market conditions).

[83] One such measure is the recently enacted Order No. 436, which encourages direct sales between producers and consumers with the pipelines merely providing a transportation service. Regulation of Natural Gas Pipelines After Partial Wellhead Decontrol, 50 Fed. Reg. 42,408 (Oct. 18, 1985), *modified*, Order No. 436-A, 50 Fed. Reg. 52,217 (Dec. 23, 1985), *modified*, Order No. 436-B, 51 Fed. Reg. 6398 (Feb. 24, 1986), *vacated*, Associated Gas Distrib. v. FERC, 824 F.2d 981 (D.C. Cir. 1987). *See* Griggs, *Restructuring the Natural Gas Industry: Order No. 436 and Other Regulatory Initiatives*, 7 ENERGY L.J. 71, 71-99 (1986)(analyzing impact of Order No. 436 on natural gas sales). Upon remand of order 436, the FERC issued Order No. 500 which reinstated virtually all the provisions of Order No. 436 and reemphasized the FERC's commitment to transform pipelines from merchants of gas to transporters of gas bought and sold by others. Order No. 500, *Regulation of Natural Gas After Partial Wellhead Decontrol*, 40 FERC ¶ 61,172 (1987). *See*

the other hand, there is currently much litigation between producers and pipelines arising out of the market's inability to absorb all gas available for sale.[84] Since pipeline purchasers cannot take all the gas they have contracted to take because of the lack of market, producers are not able to produce and sell the quantities of gas they expected, even if they have pipeline contracts.[85] It is impossible to maintain a sufficient cash flow.[86] Many producers have suffered financial difficulties.[87] In many areas, some producers are selling gas while others do not have a market and cannot sell any. Where this occurs in a common source of supply,[88] producers without a market risk drainage[89] by those who have a market. Just as the consuming public turns to the FERC when problems arise, the producers turn to their state conservation commissions.

III. The Role of the State Conservation Commission

As outlined above, throughout the history of the gas industry the relationship between supply and demand has been anything but consistent. Initially, the lack of pipeline transportation meant little demand. Subsequently, substantial pipeline reserve requirements tied up excessive reserves. Therefore, supply basi-

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IV Natural Recourses Law-1987: The Year in Review 44-51 (1987).

[84] *See, e.g.*, International Minerals & Chem. Corp. v. Llano, Inc., 770 F.2d 879, 884 (10th Cir. 1985)(purchaser in breach of take-or-pay clause), *cert. denied*, ___ U.S. ___, 106 S. Ct. 1196, 89 L.Ed 2d 310 (1986); Danden Petroleum, Inc. v. Northern Natural Gas Co., 615 F. Supp. 1093, 1095 (N.D. Tex. 1985)(same); Sid Richardson Carbon & Gasoline Co. v. Internorth, Inc., 595 F. Supp. 497, 498-99 (N.D. Tex. 1984)(same). *But see* Lively Exploration Co. v. Valero Transmission Co., No. 2930 (D. Ct. Sutton Co, Tex. May 4, 1987)(jury verdict that pipeline not liable for take or pay obligations). *See generally*, W. Watson, *Fundamentals of Gas Marketing Contracts*, Vol. XXXII, No. 7 Landman 7 (Sept/Oct 1987)(listing 382 cases involving take or pay or other gas contract disputes).

[85] *See* Note, *supra* note 74, at 619-20 (noting detrimental impact on producers as well as purchasers).

[86] *See supra* note 79 (one of historical benefits of take-or-pay clauses operating in traditional industry environment was guarantee of steady income).

[87] *See supra* note 83.

[88] *See* Manual of Oil and Gas Terms, *supra* note 1, at 140 (defining common source of supply as all underground reservoir containing common accumulation of oil, gas, both").

[89] Drainage is "[m]igration of . . . gas in a reservoir due to a pressure reduction from wells bottomed in the reservoir." Manual of Oil and Gas Terms, *supra* note 1, at 239.

cally exceeded demand through the early sixties. However, in the seventies there was a severe shortage in the interstate market. The eighties, by contrast, have seen an unprecedented decline in demand, thus resulting in the current glut. Throughout the changes in the supply/demand picture, state conservation commissions have been charged with protecting the often-competing interests of gas producers and the public.

A. The Power of the States to Prevent Waste and Protect Correlative Rights

Because of the physical nature of oil and gas, mineral owners have competing interests therein. In a common pool, oil and gas moves beneath the surface. Therefore, it is possible for one well owner to drain oil and gas from beneath anothers' land.[90] Very early, the courts recognized this conflict.

For example, in *Ohio Oil Co. v. Indiana*,[91] a producer of oil was venting gas into the atmosphere in contravention of an Indiana regulation.[92] In response to an enforcement action, the producer challenged the constitutionality of the Indiana law on the ground that any regulation restricting its right of production constituted a taking of property without due process or just compensation.[93] In *Ohio Oil*, the producer's position was based upon the assertion that all oil and gas beneath a tract is possessed by the mineral owner who has the right to produce the same as he sees fit.[94] The state, on the other hand, argued that the mineral owner has no property rights in oil and gas in place, but acquires such rights only upon reducing the same to possession.[95] Prior to that time, the state argued that it owned the minerals and therefore had the power to regulate production

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[90] *See* Northern Natural Gas Co. v. State Corp. Comm'n, 188 Kan. 355, 362 P.2d 599, 602 (1961)(describing drainage phenomenon); Shell Oil Co. v. James, 257 So. 2d 488, 494-95 (Miss. 1971)(same); *see also* Kuntz, *Correlative Rights in Oil and Gas*, 30 MISS. L.J. 1, 1-9 (1953)(same).

[91] 177 U.S. 190 (1900).

[92] *Id.* at 190-92, 192 n.1. The case sets out in full the regulation in issue. *Id.*

[93] *Id.* at 200.

[94] *Id.* at 198-99.

[95] *Id.* at 201.

and prevent waste.[96]

The Supreme Court recognized that, because of the physical properties of oil and gas, the production by one mineral owner could work to deprive an adjoining mineral owner of his rights.[97] Thus, the Court held that there exists a coequal right in all the owners to take and that the state has the power to protect the rights of all by regulating the production of oil or gas.[98] A separate but equally substantial basis for state regulation of production was to prevent waste, thereby preserving these valuable fuels for the public.[99] The Supreme Court held that it was a proper exercise of the state's police power to regulate production of oil and gas in order to prevent waste and protect correlative rights.[100] Thus Indiana's regulation was not an improper taking of Ohio Oil's private property, but a proper protection of the property rights of others and the public generally.[101]

Once the police power of the state to protect correlative rights and to prevent waste was established, the states took two general approaches to achieve those goals. On the one hand, ratable production, or proration, statutes were enacted.[102] These statutes operate to prohibit production in excess of certain quantities set by the state, with each producer being allocated his share of the allowed production.[103] The other approach is characterized by the ratable take statutes.[104] These statutes are

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[96] *Id.* at 192-97.

[97] *Id.* at 201-05.

[98] *Id.* at 209-10. These coequal rights of all mineral owners in a common source of supply have become known as "correlative rights." MANUAL OF OIL AND GAS TERMS, *supra* note 1, at 178-79.

[99] *Ohio Oil Co.*, 177 U.S. at 209-10.

[100] *Id.* at 211-12.

[101] *Id.*

[102] *E.g.*, KAN. STAT. ANN. § 55-703 (Supp. 1983)(statutory enactments limiting amounts of production); N.M. STAT ANN. § 70-2-16 (1978); OKLA. STAT. ANN. tit. 52, § 239 (West 1969)(same); TEX. NAT. RES. CODE ANN. § 86.084 (Vernon 1978)(same).

[103] *See* MANUAL OF OIL AND GAS TERMS *supra* note 1, at 695-697 (describing prorationing); Note, *Natural Gas Regulation and Vested Property Interests: Ratable Taking Proration Standards, and Fieldwide Civil Liability*, 62 TEX. L. REV. 691, 703-05 (1983)(same).

[104] *E.g.*, KAN. STAT. ANN. § 55-703 (Supp. 1983)(statutory enactments of ratable take schedules); N.M. STAT. ANN. § 70-2-19 (1978)(same); OKLA. STAT. ANN. tit. 52, § 240 (West 1969)(same); TEX. NAT. RES. CODE ANN. § 11.086 (Vernon 1978)(same); WYO. STAT. § 30-5-125 (1977)(same).

focused upon the purchaser of oil or gas and require that purchaser in a common pool to take ratably from all producers.[105] The purpose of both types of statutes is to prevent waste and the abuse of correlative rights resulting from disproportionate production of gas by various interest owners.[106]

B. The Constitutionality of Ratable Take Statutes

State ratable take orders have suffered a checkered career in the courts. For example, in *Cities Service Gas Co. v. Peerless Oil & Gas Co.*,[107] the Supreme Court considered two Oklahoma regulations, a ratable take statute and a minimum price regulation increasing the minimum allowable price to be paid for natural gas up to a level of 7 cents per thousand cubic feet (Mcf).[108] The Court upheld both the minimum price and ratable take rules against due process, equal protection and commerce clause challenges.[109] The first two challenges were disposed of on the basis that the state's interest in preventing waste and protecting correlative rights authorized "control over production even though the uses to which the property may profitably be put are restricted."[110] The commerce clause challenge was rejected because

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[105] *See* MANUAL OF OIL AND GAS TERMS, *supra* note 1, at 721 (defining ratable taking).

[106] *See* Note, *supra* note 103, at 697-706 (noting interplay of prorationing, ratable taking in Texas, common purposes of each).

[107] 340 U.S. 179 (1950).

[108] *Id.* at 183. The minimum price regulation was justified on the grounds that a ratable take requirement allowing purchases at excessively low prices actually encouraged waste, caused loss to royalty owners and discriminated against other producers in the field. *Id.*

[109] *Id.* at 185-88. In an uncharacteristically brief opinion led by Justice Clark, the Court described the due process and equal protection issues as "virtually without substance." *Id.* at 185. The Court further found the commerce clause challenge "similarly lacking in merit." *Id.* at 186. In an aside, Justice Black expressed his belief that the whole basis for appeal was "frivolous." *Id.* at 189. Not surprisingly, the decision was considered a resounding victory for state ratable take statutes at that time. The celebration, however, was brief.

[110] *Id.* at 186 (citing Walls v. Midland Carbon Co., 254 U.S. 300, 317 (1900)). Because the defendant, Cities Service, was not only the purchaser, but also the major producer in the field, this case did not consider the application of a ratable take statute in the traditional sense. The Supreme Court justified the statute on the basis of state control of production, not the taking, of gas. Indeed, the case is arguably not a ratable taking case at all, but a ratable production case.

the price increases involved were so small that they comprised only a "fraction of the price paid by domestic consumers at the burner-tip."[111] Thus, there was, in fact, no significant burden on interstate commerce.[112] However, the decision did not even consider the applicability of the supremacy clause.[113]

Although the *Peerless* court upheld the validity of ratable take regulations, that validity was short-lived. In 1963, the United States Supreme Court decided the landmark case of *Northern Natural Gas Co. v. State Corp. Comm'n.*[114] Therein *Northern Natural*, an interstate pipeline purchaser had a contract (the Republic "A" contract) which required it to purchase 60% of its market demands in a certain area from wells committed to that contract.[115] The pipeline's other contracts in the field required it to purchase ratably among those wells, but specifically excepted the Republic "A" wells from this ratable take re-

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[111] *Id.* at 187.

[112] *Id.* The decision on the commerce clause grounds is now subject to serious question. In *Peerless*, Oklahoma found that an excessively low gas price promoted waste of natural gas. The state thus ordered a price increase from a range of 3.6 to 5 cents per thousand cubic feet up to 7 cents. *Id.* at 181-83.

In FPC v. Corporation Comm'n, 362 F. Supp. 522 (W.D. Okla. 1973), *aff'd* 415 U.S. 961 (1974), subsequent Oklahoma regulations which set a minimum price of 20 cents per mcf were found to place an impermissible burden on interstate commerce. *FPC* at 535. The district court found that "*Peerless* no longer controls insofar as it holds that minimum price orders are not within the proscription of the commerce clause." *Id.* at 535. One basis for distinguishing *Peerless* was the difference in amount of the minimum price orders and their impact on the ultimate consumer. The three-judge panel stated:

> The court said in *Peerless*, that "the wellhead price of gas is but a fraction of the price paid by domestic consumers at the burner-tip, so that the field price as herein set may have little or no effect on the domestic delivered price." In *Phillips*, however the court declared that "rates charged may have a direct and substantial effect on the price paid by the ultimate consumers." And be it noted that Mr. Justice Clark, who spoke for the court in *Peerless*, dissented in *Phillips*.

Id. at 535.

[113] *Peerless*, 340 U.S. at 188-89. This issue would not be addressed by the Supreme Court until the decision in Natural Gas Pipeline Co. v. Panoma Corp., 349 U.S. 44 (1955), holding that states could not attempt to fix minimum price to be paid for natural gas after production and gathering by pipeline companies as such was the exclusive province of the Federal Power Commission under the NGA (*citing Phillips*). *See supra* notes 14-15 and accompanying text.

[114] 372 U.S. 84 (1963).

[115] Northern Natural Gas Co. v. State Corp. Comm'n, 188 Kan. 355, 362 P.2d 599, 600 (1961)(hereinafter *Northern Natural*).

quirement, thus giving the Republic wells a priority in satisfying Northern Natural's market demand.[116]

Prior to the time the controversy in *Northern Natural* arose, Kansas had enforced ratable production based on market demand. Northern Natural's nominations of its available market demand was the principal factor in setting allowables which governed the production from the wells connected to Northern Natural.[117] Consequently, the gas production from all the wells connected to Northern's pipeline in the field in question was roughly equivalent to Northern's market demand.[118] Under such circumstances, Northern was able to take ratably from all producers.[119]

However, Kansas later changed its regulatory approach, placing much greater weight in setting allowables on factors other than pipeline market demand.[120] The result was an increase in allowables significantly above Northern Natural's market demand.[121] That fact, coupled with Northern's contractual obligation to take more under the Republic "A" contract than from others, resulted in disproportionate production.[122]

To rectify the problem, the Kansas Corporation Commission entered both specific and general orders requiring the pipeline to ratably purchase Kansas gas.[123] Northern Natural objected to enforcement of the ratable take rule under these circumstances because the rule, together with the take-or-pay provisions in its contracts,[124] forced it to make a "Hobson's

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[116] *Id.* at 601.

[117] *Northern Natural*, Brief for Amicus Curiae, Federal Power Commission, at 6 (hereinafter "Brief of FPC").

[118] *Northern Natural*, 188 Kan. 355, 362 P.2d at 601.

[119] *Id.* at 606 (Schroeder, J., dissenting).

[120] *Northern Natural*, Brief of FPC at 6-12.

[121] *Northern Natural*, 372 U.S. at 87-88.

[122] *Id.*

[123] *Id.* at 88.

[124] *See supra* note 81. A take-or-pay provision is common in gas purchase contracts. It provides for the pipeline to take and pay for on an annual basis a certain minimum quantity of gas available for sale or, if it fails to take the minimum quantity, to nevertheless pay for the gas with the right to make it up at a later date. These take-or-pay payments are capitalized and a return thereon is recovered from the pipeline's customers in the form of higher gas cost. *See Northern Natural*, 372 U.S. at 99, n.1 (Harlan, J., dissenting)(discussion of take-or-pay provisions).

choice", one where either alternative adversely affected avenues to comply. First, it could reduce its purchases under the Republic "A" contract. However, this would expose it to liability under that contract's take-or-pay clause for gas not taken. Second, it could increase its takes from other wells to levels which would be ratable with its Republic "A" purchases. However, this would result in taking of gas for which it had no market. This action would require the pipeline to cut back its purchases elsewhere, resulting in take-or-pay obligations under other contracts.[125]

On appeal to the Supreme Court, the Kansas orders were overturned on preemption grounds. The principal ground for the Court's decision was that the Kansas orders, together with the take-or-pay provisions of the pipeline's contracts, would increase the consumer price of gas. The Court observed that even before passage of the NGA, states could not directly regulate the prices of wholesales of natural gas in interstate commerce.[126] Next, the Court noted that Congress provided for federal, rather than state, regulation of the prices of interstate wholesales of natural gas under the NGA.[127] Although the Kansas orders did not attempt to directly regulate gas prices, they did have an indirect price impact. This indirect price impact was held to conflict with federal regulation:

> The federal regulatory scheme leaves no room for either direct state regulation of the prices of interstate wholesales of natural gas, . . . or for state regulations which would indirectly achieve the same result. These state orders necessarily deal with matters which directly affect the ability of the Federal Power Commission to regulate comprehensively and effectively the transportation and sale of gas, and to achieve the uniformity of regulation which was an objective of the Natural Gas Act.[128]

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[125] *Id.* at 99, n.1 (Harlan, J., dissenting).

[126] *Id.* at 90.

[127] *Id.* at 91. In reaching this conclusion, the court cited Phillips Petroleum Co. v Wisconsin, 347 U.S. 672, 682 (1954) which extended FPC jurisdiction to the regulation of the rates of interstate wellhead sales and Natural Gas Pipeline Co. v. Panoma Corp., 349 U.S. 44 (1955) which, relying on *Phillips*, overturned Oklahoma orders fixing a minimum price for gas. *Northern Natural*, 372 U.S. at 91.

[128] *Id.* at 91-92.

Kansas had attempted to justify the ratable take orders under its general conservation powers.[129] The Court, however, rejected this contention, stating:

> Thus our cases have consistently recognized a significant distinction, which bears directly on constitutional consequences between conservation measures aimed directly at interstate purchasers and wholesales for resale and those aimed at producers and production. The former cannot be sustained when they threaten, as here, the achievement of the comprehensive scheme of federal regulation.[130]

From the time of the *Northern Natural* decision in 1963 until the passage of the Natural Gas Policy Act in 1978, ratable take regulations which impacted pipeline cost structures were unquestionably unconstitutional. However, with passage of the NGPA, Congress "deregulated" the first sale price of certain categories of natural gas.[131] As noted previously, the immediate effect of this "deregulation" was an increase in the price of these categories of natural gas.[132] Beginning in 1982, however, supply began to exceed demand.[133] When their markets began to demand less gas than was available at the wellhead, the pipelines first step was to cease purchasing gas that they had no contractual obligation to purchase.[134]

In Mississippi, the actions of Transcontinental Gas Pipe Line Corporation (Transco) were typical. In the summer of 1982, Transco ceased its purchases of noncontract, high-cost gas from Mississippi producers.[135] In response, these noncontract produc-

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[129] *Id.* at 93.

[130] *Id.* at 94.

[131] *See* 15 U.S.C. § 3431 (1982)(statute identifying categories of natural gas).

[132] *See supra* notes 52-58 and accompanying text (discussion of necessity of higher prices to encourage production).

[133] *See supra* notes 63-73 and accompanying text (noting conservation measures decreased demand, simultaneously increased the supply).

[134] *See supra* notes 82-83 and accompanying text (noting many purchasers' inability to purchase even contractually committed gas because of market's inability to absorb all gas available for sale).

[135] Transcontinental Gas Pipeline Corp. v. State Oil & Gas Bd., 457 So. 2d 1298, 1309 (Miss. 1984), *rev'd* 106 S. Ct. 709. Prior to that time, Transco had purchased virtually all the gas tendered to it because its market demand was sufficient to permit resale of those supplies. Thus, its purchases prior to the summer of 1982 were, in fact, ratable.

ers filed an action before the State Oil and Gas Board of Mississippi seeking to enforce its ratable take rule, Statewide Rule 48.[136] Transco challenged the application of Rule 48 on numerous grounds, arguing principally that Rule 48 was unconstitutional under both the supremacy and commerce clauses of the United States Constitution. Nevertheless, the board found Transco in violation of Rule 48 and ordered it to purchase ratably from both contract and non-contract producers. In so doing, the Board ignored the fact that its action placed Transco in the same dilemma faced by the pipeline in *Northern Natural* — having to alter purchasing patterns in a manner which, in conjunction with the take-or-pay provision of Transco's contracts, would necessarily impact its cost structure.[137] The board's order was affirmed on appeal to the Circuit Court of Hinds County, Mississippi, and again affirmed on subsequent appeal to the Mississippi Supreme Court.[138] Transco then appealed the Mississippi decision to the United States Supreme Court.

The problem Transco presented to the Supreme Court arose from a combination of Mississippi's Rule 48, the state's method of setting allowable production, Transco's gas purchase contracts

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Id. at 1307-08.

[136] *Id.* at 1311. Mississippi's statewide Rule 48 stated:

> Each person now or hereafter engaged in the business of purchasing oil or gas from owners, operators, or producers shall purchase without discrimination in favor of one owner, operator, or producer in the same source of supply.

Id. at 1311.

[137] State Oil & Gas Bd. of Mississippi Order No. 409-82 (October 13, 1982). This order required Transco to:

> . . . comply with statewide Rule 48 of the State Oil and Gas Board of Mississippi in its purchases of gas from the East Harper Sand Gas Pool in Greens Creek and East Morgantown Fields and . . . ratably take and purchase gas without discrimination in favor of one owner operator or producer against another in the said common source of [sic] pool; and, specifically, in the event it so chooses and elects to take and purchase gas from said common pool, Transco shall ratably take and purchase without discrimination in favor of the operators, Getty and Tomlinson against Coastal, the Fairchilds, and Texaco.

Id. (quoted in *Transco*, 457 So. 2d at 1311).

The order was subsequently affirmed in full on appeal to the Circuit Court of the First Judicial District of Hinds County, Mississippi, pursuant to MISS. CODE ANN. § 53-1-29 (Supp. 1983), which allowed for the appeal. *Transco*, 457 So. 2d at 1311.

[138] *Transco*, 457 So. 2d at 1332-33.

and the market situation.[139] Specifically, Transco had gas purchase contracts with very high price and take-or-pay quantity provisions.[140] When Transco's market demand fell below its available supply in 1982, it ceased purchasing any gas it was not contractually committed to purchase.[141] Mississippi's action required Transco to take this noncontract gas ratably with its contract purchases.[142] Mississippi also encouraged producers to produce their wells at maximum allowable rates.[143] Since Transco could not even meet its minimum purchase requirements under its contracts, it obviously could not take additional gas to bring noncontract producers up to ratable levels. Its only option was thus to reduce its contract purchases to levels at which ratable takes would become possible. This action had several adverse effects. First, the increased take-or-pay obligation would have resulted in increased consumer prices for gas. Second, if the rule were applied throughout Mississippi, it would have had the effect of forcing Transco to purchase more gas from Mississippi at the expense of other producer states.

Transco, relying on *Northern Natural*,[144] argued that these price increases conflicted with the federal objective of low consumer prices and with FERC authority to regulate Transco's resales rates.[145] Transco also argued that the effect of the regulation was to benefit Mississippi gas producers at the expense of the consumer, by increasing gas acquisition costs,[146] and other states, by forcing Transco to purchase more gas in Mississippi.[147]

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[139] *See Transco*, 106 S. Ct. at 711-14 (outlining basis for Transco's appeal).

[140] *See supra* note 79 and accompanying text (discussion of take-or-pay provisions).

[141] *See supra* note 135.

[142] *Transco*, 457 So. 2d at 1332-33.

[143] The Oil and Gas Board determined that it would not consider market demand in setting well allowables. Consequently, the State allowed all producers to produce at the maximum efficient rate (MER) of flow.

[144] *See supra* notes 112-127 and accompanying text (analyzing Supreme Court's finding of federal preemption in *Northern National*).

[145] Brief for Appellant at 25-29, *Transco*, 106 S. Ct. at 716.

[146] Brief for Appellant at 30-32. The Mississippi Supreme Court had rejected this argument as "simply one inevitable consequence of the free market policies of the era of deregulation with respect to which Transco is vested by the negative commerce clause with no right to complain." *Transco*, 457 So. 2d at 1322.

[147] Brief for Appellant at 32-33. On this point, the Mississippi Supreme Court asserted that producers in other states, notably Texas and Louisiana, enjoyed similar pro-

In response, the producers and the state argued that the NGPA had "deregulated" certain categories of natural gas, thereby eliminating federal jurisdiction over these categories.[148] They asserted that *Northern Natural* was inapplicable because it was decided at a time when all interstate gas was subject to federal wellhead price regulation.[149] Thus, they contended that there was now a regulatory void into which the states could step to regulate at the state level that which the federal government had deregulated — the wellhead sale of deregulated gas.[150]

The starting point of the Supreme Court's analysis was *Northern Natural*, which it observed "struck down, on preemption grounds, a virtually identical regulation."[151] The Court then reconsidered *Northern Natural* and its preemption holding in light of deregulation under the NGPA.[152] The Court explained the basis for its earlier preemption finding as follows:

> *Northern Natural's* finding of pre-emption thus rests on two considerations. First, Congress had created a comprehensive regulatory scheme, and ratable-take orders fell within the limits of that scheme rather than within the category of regulatory questions reserved for the States. Second, in the absence of ratable-take requirements, purchasers would choose a different, and presumably less costly, purchasing pattern. *By requiring pipelines to follow the more costly pattern, Kansas' order conflicted with the federal interest in protecting consumers by ensuring low prices.*[153]

With respect to the first consideration, the Court made clear that "the category of regulatory questions reserved for the States" included conservation measures such as "reasonable regulations to prevent economic and physical waste of natural gas"

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tection from ratable-take regulations. *Transco*, 457 So. 2d at 1322. Additionally, the court suggested that it was not the state's ratable-take rule which was at fault, but Transco's free and voluntary entry into the now-troublesome take-or-pay contracts. *Id.*

[148] Brief for Appellant at 7-12, *Transco*, 106 S. Ct. at 716 (1986).

[149] Brief for Appellee at 10-11.

[150] Brief for Appellee at 10-12 (*citing* Hillsborough County, Fla. v. Automated Medical Laboratories, Inc., 471 U.S. 707 (1985)). *Transco*, 106 S. Ct. at 716.

[151] *Transco*, 106 S. Ct. at 711.

[152] *Id.* at 714-18.

[153] *Id.* at 715-16 (emphasis added).

and measures designed to protect the correlative rights of owners.[154] The problem with a state regulatory scheme based solely on ratable-*take* requirements is that it does not "target producers and production," but rather is "aimed directly at interstate purchasers and wholesales for resale."[155] Although the comprehensive federal regulatory scheme does not now reach producers and production of deregulated gas, it does cover interstate purchasers and wholesales for resale.[156]

The principal concern of the Court was that Mississippi's ratable-take order would affect Transco's costs and purchasing patterns since it was "aimed" solely at purchasers with no limitations on the producers.[157] The Court noted that Congress, in enacting the NGPA, intended that "the supply, the demand, and the price of high-cost gas be determined by market forces."[158] Certainly, an order which required Transco to take more gas from Mississippi than its market dictated ran afoul of this proscription.[159] The requirement to take noncontract gas also triggered contract take-or-pay provisions, thereby increasing the cost above marketable levels.[160] The Court noted that such a price increase would frustrate "the federal goal of ensuring low prices."[161]

The Supreme Court rejected the appellees' arguments based upon NGPA deregulation.[162] It held that deregulation was a congressional determination that market forces, not federal regulation, should determine the demand and price for deregulated gas:[163]

> That FERC can no longer step in to regulate directly the prices at which pipelines purchase high cost gas, however, has little to do with whether state regulation that affect a pipeline's cost

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[154] *Id.* at 715 (quoting *Peerless*, 340 U.S. at 185).
[155] *Id.* (quoting *Northern Natural*, 372 U.S. at 94).
[156] *Id.* at 715-16.
[157] *Id.* at 717-18.
[158] *Id.* at 716-17.
[159] *Id.* at 717-18.
[160] *Id.*
[161] *Id.* at 718.
[162] *Id.* at 716-17.
[163] *Id.*

> and purchasing patterns impermissibly intrude upon federal concerns. Mississippi's action directly undermines Congress' determination that the supply, the demand, and the price of high cost gas be determined by market forces.[164]

According to the Court, such a "federal decision to forego regulation in a given area may imply an authoritative federal determination that the area is best left *un*regulated and in that event would have as much preemptive force as a decision *to* regulate."[165] Despite the changes in the gas industry under the NGPA, the Court still found no room for direct state regulation which threaten "to distort the market once again by artificially increasing price and supply."[166]

Clearly, the Supreme Court has stated that ratable take rules are unlawful. *Northern Natural* prohibits their use with regulated gas while *Transco* prohibits their use with deregulated gas. The principal evil in both cases is that such orders interfere with federal authority by increasing consumer gas prices. Additionally, they impose purchase requirements on pipelines different from that dictated by market demand.

C. The Constitutionality of Proration Statutes

Several United States Supreme Court cases have construed the validity of state proration, or ratable production, orders. In 1932, the United States Supreme Court decided the landmark case of *Champlin Refining Co. v. Corporation Comm'n.*[167] A challenge was made to Oklahoma's law prohibiting oil production in such a manner as to constitute waste.[168] In upholding the constitutionality of oil proration the Court stated:

> In Oklahoma, as generally elsewhere, land owners do not

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[164] *Id.* at 716-17.

[165] *Id.* at 717 (quoting Arkansas Elec. Coop. Corp. v. Arkansas Public Service Comm'n, 461 U.S. 375, 384 (1983)).

[166] *Id.* at 718. Because the Court disposed of the case on pre-emption grounds, it never reached the commerce clause issue. *Id.* at 718.

[167] 286 U.S. 210 (1932).

[168] The law in question defined waste to include "economic waste, [surface waste] and waste incident to the production of crude oil in excess of transportation or marketing facilities or reasonable market demands." *Champlin*, 286 U.S. at 215.

> have absolute title to the gas and oil that may permeate below the surface. These minerals, differing from solids in place such as coal and iron, are fugacious and of uncertain movement within the limits of the pool. Every person has the right to drill wells on his own land and take from the pools below all gas and oil that he may be able to reduce to possession, including that coming from land belonging to others; but the right to take and thus to acquire ownership is subject to the reasonable exertion of the power of the State to prevent unnecessary loss, destruction or waste. And that power extends to the taker's unreasonable and wasteful use of natural gas pressure available for lifting the oil to the surface and the unreasonable and wasteful depletion of a common supply of gas and oil to the injury of others entitled to resort to take and take from the same pool.[169]

Further, in rejecting a challenge based upon the commerce clause, the Court stated:

> It is clear that the regulations . . . apply only to production and not to sales or transportation of crude oil or its products. Such production is essentially a mining operation and therefore is not a part of interstate commerce even though the product obtained is intended to be and in fact is immediately shipped in such commerce.[170]

Although *Champlin* clearly held proration orders to be constitutional, the Supreme Court, only a few years later, pointed out that the state's authority in this area was not unlimited. In *Thompson v. Consolidated Gas Utilities Corp.*,[171] the Court held that "proration orders would not be valid if shown to bear no reasonable relation either to the prevention of waste or the protection of correlative rights."[172]

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[169] *Id.* at 233-34.

[170] *Id.* at 235.

[171] 300 U.S. 55 (1937).

[172] *Thompson*, 300 U.S. at 69. The orders in issue in *Thompson*, promulgated by the Texas Railroad Commission limited the production of sweet gas to an amount below market requirements under existing contracts, and below transportation and marketing facilities' capacity. *Id.* at 58. The state contended that the purpose was merely waste prevention and protection of the correlative rights of owners in the common source of supply. *Id.* The plaintiffs, on the other hand, seeking to enjoin enforcement, contended, *inter alia*, that the order violated federal due process requirements and exceeded the

Only three years later, in 1940, the Supreme Court again examined a proration case, *Railroad Commission of Texas v. Rowan & Nichols Oil Co.*[173] In *Railroad Commission*, the Court analyzed an oil proration order promulgated by the Railroad Commission of Texas. In an effort to deal with an extraordinary lack of market for oil, the Railroad Commission reduced production to only 2.32% of each well's unrestricted flow, while allowing marginal wells a greater flow.[174] The Court upheld the orders on the ground that they were enacted for the legitimate purpose of prevention of waste and the protection of correlative rights in an effort "to compel those who may legally produce, because they have market outlets for permitted uses, to purchase [oil] from potential producers whom the statute prohibits from producing because they lack such a market for their possible product."[175] Thus, requiring producers to share the available market was deemed to be legitimate state regulation.

More recently, in *Northern Natural*,[176] the Supreme Court noted that the rationale of *Champlin* was equally applicable to gas production and that gas proration orders were therefore constitutional.[177] However, from 1970 to 1982, proration orders had little significance since the market demand exceeded supply. Obviously, when the market can consume all gas that is produced, there is no need to prorate production on the basis of market demand.

Since 1982, the circumstances which would prompt market demand proration have again surfaced. However, it was not a popular approach with producers having pipeline purchase contracts. The reason is simple. Market demand prorationing is

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authority of the state Railroad Commission. *Id.*

In affirming the district court's injunction, the Court noted that the orders failed the reasonable relation test based upon special fact findings of the lower courts. *Id.* at 70. Specifically, plaintiffs proved to the Court's satisfaction, that there was "no present danger that the pipeline owners [would] . . . cause waste or prejudice either to any public interest, or to a property right of any other person." *Id.*

[173] 310 U.S. 573 (1940).

[174] *Railroad Comm'n*, 310 U.S. at 577.

[175] *Id.* at 583, n.1 (quoting *Thompson*, 300 U.S. at 77).

[176] *See supra* notes 112-127 and accompanying text (analyzing Supreme Court's finding of federal preemption in *Northern Natural*).

[177] *Northern Natural*, 372 U.S. at 94.

necessary to prevent waste when supply exceeds market demand. When a state reduces legal production allowables to give all producers an opportunity to share that market demand, the producer with a contract can no longer produce and sell all the available production and cannot even collect take-or-pay payments.[178] In the eyes of the contract producer, therefore, the ratable take approach (without market demand proration) is preferable because it achieves ratable production without legally restraining their ability to produce and sell gas.[179] Of course, under *Transco* such an approach is unconstitutional.

Proration orders are criticized on yet another ground. Many producers argue that market demand proration and ratable production orders are simply ineffective. The theory is that market demand is apportioned among all wells in a common pool in order to allow all to produce a share of the market.[180] However, it is argued that such action would be meaningless without a corresponding ratable take requirement that pipelines purchase from noncontract producers. Without such a requirement, a producer without a purchase contract would still produce nothing and the ratable production requirement would operate to cause contract producers to be overproduced although they are producing less.[181]

Finally, recent regulatory changes by the FERC have resulted in more and more pipelines having to transport gas for others.[182] Thus, distribution companies and end users now have a much greater ability to directly purchase gas supplies anywhere in the country and to seek pipeline transportation for that

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[178] Take-or-pay payments are made by a purchaser in lieu of accepting current deliveries of gas. Where production is legally prohibited, the producer could not have delivered the gas even if requested by the purchaser. The result is that take-or-pay payments are not collectible. Northern Natural Gas Co. v. Republic Natural Gas Co., 172 Kan. 450, 251 P.2d 807, 723-24 (1952); *see supra* notes 69-75 and accompanying text (general discussion of market condition's effect on demand).

[179] *See* McDonald, *Prorationing of Natural Gas Production: An Economic Analysis*, 57 U. COLO. L. REV. 153, 161-62 (1986)(economic views of ratable take).

[180] *See supra* note 101 and accompanying text; *see also Transco*, 106 S. Ct. at 715, n.3 (illustration of prorationing in practice).

[181] *Transco*, 106 S. Ct. at 715; *see also* Note, *supra* note 101, at 713-17, 723-25 (discussing symbiotic relationship which must exist between ratable, prorationing statutes).

[182] *See supra* note 83 and accompanying text.

gas. When states, in the face of this new flexibility, attempt to address problems by only reducing allowable production through market demand proration orders, they run the risk that the purchaser will merely shift its purchases to producers in other states. Obviously, state attempts to allocate limited market demand which further reduce gas purchases in that state are not viable solutions to the problem. Thus, a market demand ratable production statute, though clearly constitutional, would not effectively achieve the state's purposes of preventing waste and protecting correlative rights.

IV. Oklahoma's Priority Rules — A Constitutional Synthesis Between Ratable Production and Ratable Taking

This article has previously noted why ratable take rules are unconstitutional and why ratable production rules can be ineffective. It is the authors' opinion that a synthesis of the two approaches is possible, one which achieves the legitimate purposes of the state while not running afoul of federal regulation as in *Transco* and *Northern Natural.*

Before discussing this approach, it is useful to first recall the respective interests. The states desire to prevent waste of a valuable resource, both physical and economic, and to protect correlative rights.[183] The federal government, on the other hand, requires that any state action to achieve these goals must not impose on the interstate purchaser (and consequently the consumer) any alteration of present purchasing patterns which would increase the cost of gas.[184]

It is submitted that Oklahoma law can satisfy the concerns of both the state and federal government. Since 1915, Oklahoma has had both a market demand ratable production statute,[185] as

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[183] *See supra* note 1 and accompanying text (definitions of waste, correlative rights).

[184] *See supra* notes 156-160 and accompanying text (discussion of how ratable take order conflicts with federal interest in lowest possible consumer gas prices).

[185] Okla. Stat. Ann. tit. 52, § 239 (West 1969).

§ 239. Common source of supply — Excess gas supply — Apportionment and regulation to prevent waste

Whenever the full production from any common source of supply of natural gas in this state is in excess of the market demands, then any person, firm or corporation, having the right to drill into and produce gas from any such

well as a ratable take statute.[186]

More importantly, in 1983, Oklahoma incorporated both section 239 and section 240 into its Priority Rules,[187] a consolidated approach to the problem of a drastic supply/demand imbalance. The Priority Rules set up four categories of gas wells

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common source of supply, may take therefrom only such proportion of the natural gas that may be marketed without waste, as the natural flow of the well or wells owned or controlled by any such person, firm or corporation bears to the total natural flow of such common source of supply having due regard to the acreage drained by each well, so as to prevent any such person, firm or corporation securing any unfair proportion of the gas therefrom; provided, that the Corporation Commission may by proper order, permit the taking of a greater amount whenever it shall deem such taking reasonable or equitable. The said commission is authorized and directed to prescribe rules and regulations for the determination of the natural flow of any such well or wells, and to regulate the taking of natural gas from any or all such common sources of supply within the state, so as to prevent waste, protect the interests of the public, and of all those having a right to produce therefrom, and to prevent unreasonable discrimination in favor of any one such common source of supply as against another.

Id.

[186] *Id.* at tit. 52, § 240 (West 1969).

§ 240: "Common purchaser" — Discrimination in purchases prohibited — Regulation of purchases

Every person, firm or corporation, now or hereafter engaged in the business of purchasing and selling natural gas in this state, shall be a common purchaser thereof, and shall purchase all of the natural gas which may be offered for sale, and which may reasonably be reached by its truck lines, or gathering lines without discrimination in favor of one producer as against another, or in favor of any one source of supply as against another save as authorized by the Corporation Commission after due notice and hearing; but if any such person, firm or corporation, shall be unable to purchase all the gas so offered, then it shall purchase natural gas from each producer ratably. It shall be unlawful for any such common purchaser to discriminate between like grades and pressures of natural gas, or in favor of its own production, or of production in which it may be directly or indirectly interested, either in whole or in part, but for the purpose of prorating the natural gas to be marketed, such production shall be treated in like manner as that of any other producer or person, and shall be taken only in the ratable proportion that such production bears to the total production available for marketing. The Corporation Commission shall have authority to make regulations for the delivery, metering and equitable purchasing and taking of all such gas and shall have authority to relieve any such common purchaser, after due notice and hearing, from the duty of purchasing gas of an inferior quality or grade.

Id.; *cf.* OKLA. STAT. ANN. tit. 52, § 23 (West 1969)(substantially identical ratable take statute directed primarily at pipeline operators).

[187] Oklahoma Corp., Comm'n, Oil and Gas Rules 1-305(b).

and require production to be taken in accordance with the priorities established for each category.[188] The takes are to be ratable within each category.[189]

The establishment of these priorities is unquestionably motivated by the necessity to prevent physical waste.[190] Wells in the top priority would be physically damaged if their production is cut back.[191] Thus, it is important for the state to avoid the loss of gas that might occur if these wells are reduced in production or are shut in.[192] Since there is insufficient market to produce gas from all wells in Oklahoma, it is important in order to prevent waste that the distress wells be given priority for production over wells that would not be harmed by reduction of production.[193]

The application of the Oklahoma law prescribed by sections 239 and 240, as implemented by the Priority Rules, are important measures for the prevention of substantial waste and for the protection of correlative rights. The importance of the state's ability to enforce such rules is without dispute.

In its order affirming the constitutionality of the Priority Rules,[194] the Oklahoma Corporation Commission made it clear that Rule 1-305 was a coordinated response to the market crisis:

> It must be emphasized that § 240 does not stand alone in its application; that it must be read in conjunction with § 239 as a means for accomplishing the state's objective.[195]

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[188] *Id.* The priorities are: priority one — hardship and distressed wells; priority two — enhanced recovery wells; priority three — wells producing casinghead gas; and priority four — all other wells. *Id.*

[189] *Id.*

[190] *See* Allison, *The Prorationing of Natural Gas in Oklahoma*, 57 U. Colo. L. Rev. 169, 192 (1986)(noting waste prevention motive of priority rules).

[191] *Id.* at 193.

[192] *Id.* (quoting In the Matter of Rules & Orders of the Corp. Comm'n Regarding Market Demand for Gas, Order No. 246, 797, at 5 (Oct. 19, 1983)).

[193] Allison, *supra* note 189, at 191.

[194] Order Determining Authority of the Commission to Require Ratable Takes of Natural Gas by First Purchasers Who May be Interstate Pipelines, *In re: Whether the Oklahoma Corporation Commission has the Authority to Require Ratable Take of Natural Gas by First Purchasers Who are Interstate Pipelines*, Order No. 281285, General Cause No. 28770 (July 3, 1985)[hereinafter "Interstate Pipeline Order"].

[195] Interstate Pipeline Order at 5.

The Commission also stated that section 240 was to be enforced only to assist in the regulation of production under section 239:

> The Commission's exercise of jurisdiction over interstate pipelines is therefore incidental to its jurisdictional mandate to regulate production pursuant to section 239 and a tool for enforcing such production regulation.[196]

The actual operation of section 239 and section 240 together was also described by the Commission:

> It seems only logical that when production is dictated by pipeline capacity and demand and limited by this agency's setting of an allowable, the pipeline must be an integral part of that production function and regulation. Section 239 sets forth circumstances under which prorating occurs and section 240 provides a means of enforcing proration requirements.[197]

Clearly, Oklahoma's regulatory scheme, based on regulation of *both* production and takes, is considerably different from that overturned in *Transco*. In *Transco*, the Supreme Court held that a state may not respond to a gas market crisis by placing the entire burden of preventing waste and protecting correlative rights on the shoulders of interstate pipelines.[198] Because the effect of Mississippi's action was to artificially increase the price and quantity of Transco's purchases from Mississippi, it was held unconstitutional.[199]

Oklahoma's quite different statutory scheme runs afoul of none of these concerns. First, the pipelines do not face the specter of balancing well output themselves. That function is undertaken by limiting production under section 239.[200] The pipelines

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[196] *Id.* at 6.

[197] *Id.* at 10.

[198] *Transco*, 106 S. Ct. at 717-18; *see supra* notes 156-160 and accompanying text (Congress intended cost of gas to be determined by market forces).

[199] *Transco*, 106 S. Ct. at 718.

[200] In general, § 239 operates schematically with two other statutes, OKLA. STAT. ANN. tit. 52, § 87.1 and § 232, and numerous administrative regulations, to limit production. Under § 239, when available production exceeds market demand, each producer is limited to its prorata share of the market. Section 239 also empowers the Oklahoma Corporation Commission to enact specific orders to redress the waste and abuse of cor-

only assist in the enforcement thereof.[201]

Second, Oklahoma does not impose greater quantity purchase requirements on pipelines. Section 239 limits production to market demand.[202] Naturally, if Oklahoma producers cannot produce more than market demands on each pipeline's system, then no pipeline is required to purchase more than its market can consume. This avoids the quantity concerns in *Transco*[203] as well as any price increases arising from the required taking of higher priced quantities of gas.[204]

Oklahoma may also avoid the price concerns of *Transco* arising from increased take-or-pay exposure.[205] To the extent that a current contract producer has its production cut back under section 239, it should not be able to recover take-or-pay.[206] *Transco* had suggested such an approach in Mississippi,

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relative rights which can occur in such circumstances. OKLA. STAT. ANN. tit. 52, § 239 (West 1969).

Section 87.1 pursues a purpose of drainage prevention in directing the OCC to apply productive capacity ratios to determine the ratable production of wells in a common source. OKLA. STAT. ANN. tit. 52, § 87.1 (West 1960).

A determination of natural flow ratios is again the standard under § 232 but applies generally to individual drilling and production rights which are not otherwise limited by considerations of total production from a common source as in § 239. OKLA. STAT. ANN. tit. 52, § 232 (West 1969).

See Sinclair Oil & Gas Co. v. Corporation Comm'n, 378 P.2d 847 (Okla. 1963)(upholding OCC's allowables determination under § 239); Anderson-Prichard Oil Corp. v. Corporation Comm'n, 207 Okla. 686, 252 P.2d 450 (1953)(same); *see also* Allison, *supra* note 191, at 172-85 (analyzing statutory, administrative production limitation in Oklahoma).

[201] In this regard, the pipelines function as a "messenger" of market demand, bearing such news to both producer and regulatory authority alike. *See infra* note 203 and accompanying text.

[202] *See supra* note 200 and accompanying text. Market demand means that quantity of gas which the consumers on a given pipeline system will purchase at a given price. *See* American Exploration Co. v. Columbia Gas Transmission Corp., 779 F.2d 310, 313 (6th Cir. 1985)(definition or market demand); *see also* Manual of Oil and Gas Terms, *supra* note 1, at 490 (same).

[203] *See supra* notes 146-157 and accompanying text (supply of gas should be determined by market forces).

[204] *See supra* notes 156-158 and accompanying text (Mississippi ratable take order was aimed solely at purchasers with no limitation on producers).

[205] *See supra* notes 145, 159-160 and accompanying text (Mississippi rule found to frustrate federal goal of lower prices).

[206] *Transco*, 106 S. Ct. at 720 (Rehnquist, J., dissenting). Many other authorities support the proposition that take-or-pay obligations are relieved to the extent the producer is precluded from producing the full contract quantity of gas. *See, e.g.*, Northern

by reducing allowables to market demand.[207] Mississippi refused this alternative,[208] however, and therefore suffered its law to be held unconstitutional. Oklahoma, on the other hand, has premised its efforts also on the ratable-production requirements in section 239. If this approach is interpreted to relieve take-or-pay obligations, then the law may pass constitutional muster.

In other words, under the Oklahoma scheme of ratable production enforced by ratable takes, the purchasers take the same volumes of gas and the same price mix of gas they would take without the rule in order to meet the demands of their customers. Under Oklahoma law, these same gas purchases would be taken from the producers ratably and in accordance with the priority rules, without incurring *any* additional cost of gas or affecting in *any* way the jurisdiction and concerns of the FERC under the federal regulatory scheme. Instead, the contract take requirements are superceded by the police power of the state. This allows the state to protect correlative rights and prevent waste without conflicting with federal regulation.[209]

Natural Gas Co. v. Republic Natural Gas Co., 172 Kan. 450, 241 P.2d 708, 723-24 (1952)(gas purchaser not liable for take-or-pay obligations on gas not produced where production was limited by state allowable); Nelson v. Galpen, 277 Mich. 529, 269 N.W. 586 , 593 (1936), *modified on other grounds sub nom.*, Nelson v. Big Rapids Gas Co., 299 Mich. 284, 300 N.W. 89 (1941)(same); Wayne & Brown v. El Paso Natural Gas Co., No. C-84-43 (Dist. Ct. of Roger Mills County, Okla., March 26, 1985)(same); 8 H. WILLIAMS & C. MEYERS, OIL AND GAS LAW, § 724.5 (1985)(same).

However, in the recent case of Golson v. ONG W., Inc., No. 65,833 (Okla. March 15, 1988), the Oklahoma Supreme Court held that the priority rules, as applied to an intrastate pipeline, did not relieve take-or-pay obligations. Of course, *Transco* only applies to interstate pipelines. A similar ruling as to interstate pipelines would cause the priority rules to be unconstitutional and would thereby deprive the state of an opportunity to achieve its legitimate conservation purposes. Whether the state will choose either conservation or enforcement of take-or-pay remains to be seen. *See infra* note 209.

[207] *Transco*, 106 S. Ct. at 714.

[208] *Id.*

[209] The Oklahoma Corporation Commission ruling that the Priority Rules are constitutional has been appealed to the Oklahoma Supreme Court. Panhandle E. Pipe Line Co. v. Corporation Comm'n, *appeal docketed* No. 65,890 (Okla. Aug. 2, 1985). This case has been briefed but no decision has been reached.

In addition, two separate challenges to the Priority Rules were filed in federal district court and subsequently consolidated. ANR Pipeline Co. v. Corporation Comm'n, No. CIV-85-1929A (W.D. Okla. filed Aug. 1, 1985), *consolidated with*, Northwest Central Pipeline Corp. v. Corporation Comm'n, No. CIV-85-1980-A (W.D. Okla. filed Aug. 8, 1985). On May 12, 1986, the court entered summary judgment in favor of the plaintiffs,

Certainly, the Oklahoma priority rules adopted pursuant to section 239 and section 240 are far different from the purely ratable take laws overturned in *Northern Natural* and *Transco*. Whether these differences will ultimately be held to preserve the constitutionality of the priority rules is an issue of great importance to the producing states. Hopefully, the courts will uphold the rules as the best method of preventing waste and protecting correlative rights without imposing unconstitutional burdens on pipelines and consumers of natural gas.

V. Will the FERC's Attempts to Change the Natural Gas Industry Into a Deregulated Market Obviate the Need for Ratable Take or Market Demand Proration Rules?

Over the past several years, the FERC has promulgated several major new rules[210] designed to change drastically the nature of the natural gas industry.[211] Of critical relevance here are

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holding that section 240 and the priority rules were unconstitutional as applied to interstate pipelines. ANR Pipeline Co. v. Corporation Comm'n, 643 F. Supp. 419, 424 (N.D. Okla. 1986), *appeal docketed*, No. 86-2481 (10th Cir. Oct. 24, 1986). The court grounded its ruling on *Northern Natural's* and *Transco's* prohibition against state regulation of interstate pipelines due to federal pre-emption. *Id.* at 421-24. This case has been briefed before the Tenth Circuit but no decision has been rendered.

The authors are not in agreement with the ruling. As discussed above, while the priority rules do apply to pipelines, they avoid placing on the pipelines any of the burdens which have been held to offend federal interests. In *Transco* and *Northern Natural*, the Supreme Court did not condemn all pipeline regulation, only that which could conflict with the federal interests of adequate service and lowest reasonable cost to the consumer. Indeed, there are many state regulations currently in force, such as pipeline reporting requirements, which are not unconstitutional in spite of their application to pipelines.

[210] *See* FERC Orders No. 436, 500. FERC Order 380 also changed the character of the natural gas industry by offering local distribution companies an opportunity to abrogate their existing firm purchase or "minimum bill" contracts with pipelines. 49 Fed. Reg. 22,778 (June 1, 1984); Order No. 380-A, 49 Fed. Reg. 31,259 (August 6, 1984); Order No. 380-B, 49 Fed. Reg. 43,635 (October 31, 1984); Order No. 380-C, 49 Fed. Reg. 43,625 (October 31, 1984), *aff'd*, Wisconsin Gas Co. v. FERC, 770 F.2d 1144 (D.C. Cir. 1985), *cert. denied*, 106 S. Ct. 1968 (1986).

[211] In Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987), the court observed:

> On October 9, 1985, the Federal Energy Regulatory Commission (FERC) issued Order No. 436, 50 Fed. Reg. 42,408 (1985)(codified at scattered sections of 18 C.F.R.). The Order envisages a complete restructuring of the natural gas industry. It may well come to rank with the three great regulatory milestones

FERC Orders No. 436 and 500 which are designed to force[212] pipelines to accept "open access" transportation as defined by those rules.[213] While the FERC's objectives with its recent orders are clear — transformation of the natural gas industry into a free market — the ultimate nature of FERC regulation and the ultimate character of the resulting natural gas industry itself is not yet certain.[214] In any event, it currently appears that more and more pipelines will accept open access transportation and that pipelines as transporters rather than merchants of natural gas will become more prevalent in the future.

> of the industry: the passage of the Natural Gas Act . . . in 1938, the imposition of price controls on independent producers' wellhead sales, under Phillips Petroleum Co. v. Wisconsin, 347 U.S. 672 (1954), and adoption of the Natural Gas Policy Act . . . .

Associated Gas Distrib., 824 F.2d at 981.

[212] Technically, Order No. 436 was "voluntary" in the sense that each pipeline was to choose whether to go open access or not. However, as the court in Associated Gas Distributors v. FERC, 824 F.2d 981 (D.C. Cir. 1987) observed, the choice is anything but "voluntary":

> FERC also alludes to the "voluntary" character of pipeline provision of Order No. 436 transportation . . . . There are two flaws in this. First, refusal of the option may spell bankruptcy: inability to provide blanket-certificate transportation for fuel-switchable users may in current market circumstances cause critical load loss. Of course acceptance of the option may also be fatal. But when a condemned man is given the choice between the noose and the firing squad, we do not ordinarily say that he has "voluntarily" chosen to be hanged.

Id. at 1024.

[213] In *Associated Gas Distrib.*, the court upheld most aspects of Order No. 436 while remanding certain parts to FERC for further consideration. Order No. 500 reinstated virtually all of the Order No. 436 regulations while also attempting to address the court's concerns in *Associated Gas Distrib. Natural Resources Law-The Year in Review* 1 at 44-51. While the precise terms of open access transportation will vary according to the needs and aims of each pipeline as well as the terms that FERC will approve, the most important common element is that pipelines who choose to accept open access status must make their pipeline available to other parties who desire to transport gas. Of critical importance to the pipeline is the fact that producers may now contract to sell gas directly to end users and have it transported by a given pipeline despite the fact that those sales may compete with and ultimately displace the pipeline's own sales on the system. The FERC's intent is to assure the function as transporters of natural gas for others, thereby reducing or eliminating their "merchant" function.

[214] For example, the Court of Appeals reversed Order No. 436 for lack of reasoned decision-making by FERC in certain critical areas, although the court held that FERC's objectives may be valid under certain circumstances. Associated Gas Distrib. v. FERC, 824 F.2d 981 (D.C. Cir. 1987). Subsequently, the FERC adopted Order No. 500 in a proposed rulemaking procedure. Order No. 500 has not yet been adopted as final and will almost certainly be appealed to the federal courts.

The implications of the availability of greater pipeline transportation on regulation of production and takes by state conservation commissions is likewise not entirely clear. On the one hand, producers, who previously could look only to pipelines to purchase their gas, can now seek contracts with pipelines, local distribution companies, end users, and natural gas brokers. On the other hand, the existence of significantly more purchasers of natural gas, each with differing natural gas needs, will increase the likelihood that producers will be operating under widely varying take requirements. Thus, the problems of waste and the abuse of correlative rights caused by disproportionate takes by gas purchasers may be exacerbated by changes in the regulatory environment. The actual purchaser in many instances will be out of state end users or distribution companies beyond the jurisdiction of the commissions.[215]

Likewise, state conservation commissions attempting to redress the problem of disproportionate takes must still avoid running afoul of the constitutional concerns at issue in *Transco*. First, interstate pipelines, which are preemptively regulated by the FERC, will still be purchasing significant quantities of natural gas for resale. Thus, states may not enforce laws against interstate pipelines which increase the cost or quantity of gas those pipelines are required to purchase. Furthermore, to the extent that these pipelines do not purchase but merely serve as transporters of natural gas, there may still be preemption concerns which affect the state's ability to direct ratable purchases. Finally, it must be remembered that the pipeline in *Transco* also challenged Mississippi's ratable take rule on commerce clause grounds, asserting that the state could not constitutionally protect Mississippi producers by placing the burden on customers in the interstate market located principally outside of Mississippi.[216] Because the United States Supreme Court overturned Mississippi's ratable take rule on preemption grounds, it found it unnecessary to reach the commerce clause question.[217] How-

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[215] If the sale is at the point of delivery, the purchaser will likely not be doing business in the state of production.

[216] *Transco*, 106 S. Ct. at 713.

[217] *Id.*

ever, to the extent that states may attempt to achieve ratable production by regulating purchases of entities which are not preemptively regulated by federal law, these commerce clause concerns may again arise.

CONCLUSION

State conservation commissions currently face a difficult task of ensuring that waste and the abuse of correlative rights does not occur during a time of drastic cutbacks in gas purchases.[218] One possible remedy, the pure ratable take approach which ignores market demand, has been foreclosed from application to interstate pipeline companies by the Supreme Court.[219] Another traditional remedy, the proration order, has been criticized as ineffective because it imposes no purchase requirements.[220] There is yet another approach, however, one which achieves the legitimate objectives of the state while not running afoul of federal concerns. This is the regulatory scheme which both limits production to market demand and requires ratable taking of that limited production.[221] This approach, as exemplified by Oklahoma's "priority rules", can be enforced in a constitutional manner to deal with current market problems as well as to handle similar problems of waste and abuse of correlative rights which may result from expected changes in the nature of the natural gas industry.

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[218] For an in-depth look at the posture of other major gas-producing states concerning prorationing and ratable take just prior to *Transco*, see, Lungren, *Natural Gas Prorationing in Kansas*, 57 U. COLO. L. REV., 267, 267-99 (1986)(Louisiana); Pearce, *Natural Gas Prorationing in New Mexico: An Attempt at Just and Equitable Allocation*, 301, 301-15 (1986)(New Mexico); Anderson, *The Texas Approach to Gas Proration and Ratable Take*, 57 U. COLO. L. REV. 225, 225-50 (1986)(Wyoming).

[219] *Transco*, 106 S. Ct. at 718.

[220] *See supra* notes 178-182 and accompanying text (using market demand proration to reduce production of producers with contracts arguably ineffective when purchasers have no obligation to take from non-contract producers).

[221] *See supra* notes 185-209 and accompanying text (description of Oklahoma scheme).

OF TIME, TIDELANDS, AND PUBLIC TRUST

*M. Casey Jarman**

Introduction

Over the past several years, increased demands for coastal resources have created disputes over the respective rights of private landowners and the public in the bayous, tidal streams, and beaches of the Mississippi Gulf Coast. These legal rights are determined by the public trust doctrine, a concept that has evolved in American jurisprudence from Roman and English law.[1] Its philosophic underpinning is that seas and shores, and the resources found within, represent a vast, inexhaustible commons whose wealth can and should be shared by all.

Mississippi's public trust doctrine has its roots in the English common law.[2] Prior to the signing of the Magna Charta in 1215, the English monarchy claimed sovereign ownership in ocean and coastal lands and waters, and the resources contained therein. Over a period of time, as the King granted many coastal waterways to lords loyal to him, sovereign lands came to be divested in a manner indistinguishable from other private prop-

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[1] *See generally* Sax, *The Public Trust Doctrine in Natural Resource Law: Effective Judicial Intervention*, 68 Mich. L. Rev. 473, *passim* (1969)(historic origins of public trust law); Stevens, *The Public Trust: A Sovereign's Ancient Prerogative Becomes the People's Environmental Right*, 14 U.C. Davis L. Rev. 195 *passim* (1980)(public trust law history); Note, *The Public Trust in Tidal Areas: A Sometimes Submerged Traditional Doctrine*, 79 Yale L.J. 762, *passim* (1970)(origins of public trust law).

[2] State v. Stewart, 184 Miss. 202, 224, 184 So.2d 44, 47 (1938). Concerning public trust doctrine ". . . Mississippi adopted the common law as it prevails in England." *Id.*

erty. The Magna Charta, which has been interpreted to have brought to a close such privatization of public lands, established the roots of the modern law of public trust.[3] It permitted the monarchy to retain sovereign rights in tidal lands and resources up to the high-water mark, but prohibited exclusive alienation to private parties for private use. Thus, a trust in favor of the public was impressed upon such lands.

Mississippi obtained ownership of its tidelands below mean high tide from the United States government under the equal footing doctrine, a legal principle which provides that states entering the Union after its initial creation came in on an "equal footing" with other states.[4] Because the original states had reserved their tidelands and navigable waters and held them in trust for the public, Mississippi became owner of its tidelands upon statehood. Prior to statehood, the federal government owned these lands in a similar trust capacity.[5]

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[3] Martin v. Lessee of Waddell, 41 U.S. (16 Pet.) 366 (1842).

> The question is not free from doubt, and the authorities referred to in the English books cannot, perhaps, be altogether reconciled. But . . . the question must be regarded as settled in England against the right of the king since the Magna Charta to make such a grant [of submerged lands] . . . . But the existence of a doubt as to the right of the king to make such a grant after Magna Charta, would of itself show how fixed has been the policy of that government on this subject for the last six hundred years; and how carefully it has preserved this common right for the benefit of the public.

Id. at 410, 412.

[4] Pollard's Lessee v. Hagan, 44 U.S. (3 How.) 212 (1845).

> The manner in which the new states were to be admitted into the union, according to the ordinance of 1787 [Northwest Ordinance], as expressed therein, is as follows: '. . . such state shall be admitted by its delegates into the congress of the United States, on an equal footing with the original states in all respects whatever.'

Id. at 222. This doctrine was extended to ensure that "new" states have the same rights as the original states in the tide waters, and in the lands below the high-water mark, within their respective jurisdictions. Shively v. Bowlby, 152 U.S. 1, 26 (1893).

[5] Knight v. United States Land Ass'n, 142 U.S. 161 (1891).

> It is the settled rule of law in this court that absolute property in, and dominion and sovereignty over, the soils under the tide waters in the original States were reserved to the several States, and that the new States since admitted have the same rights, sovereignty and jurisdiction in that behalf as the original States possess within their respective borders. Upon the acquisition of the territory from Mexico the United States acquired the title to tide lands equally with the title to upland; but with respect to the former they held it only in trust for the future States that might be erected out of such territory.

The extent of public rights in tidelands varies from state to state.[6] And within state public trust case law, courts have had difficulty in establishing the bounds of the trust. Mississippi is no exception. Several property issues have arisen in Mississippi's public trust law. First, what is the geographical boundary between private and public trust land? Second, to what extent can the state alienate trust lands in fee? Third, what private and public uses are protected by the public trust doctrine? And fourth, what public rights are impressed upon owners whose property lies upland from public trust tidelands? This article explores these issues and how they are treated under Mississippi statutory and common law.

Geographic Boundary of Tidal Public Trust Lands

1. Ebb and Flow Test

In its earliest public trust decision, Martin v. O'Brien,[7] the Mississippi Supreme Court established the high water mark as the inland geographic boundary of public trust lands.[8] One of the court's most coherent discussions on the subject is found in State ex rel. Rice v. Stewart.[9] This case involved the ownership of submerged lands in Bayou Bernard, a navigable inlet of the Mississippi Sound.[10] Contending that they owned the bed of the bayou and the minerals contained therein, the adjacent upland

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Id. at 183.

[6] Shively v. Bowlby, 152 U.S. 1 (1893).

> . . . there is no universal and uniform law upon the subject; but that each State has dealt with the lands under the tide waters within its borders according to its own views of justice and policy, reserving its own control over such lands, or granting rights therein to individuals or corporations, whether owners of the adjoining uplands or not, as it considered for the best interests of the public.

Id. at 26. *See, e.g.* City of Newport Beach v. Fager, 102 P.2d 438, 441 (Ca. App. 1940)(legislature may alienate tidelands from public trust if public interest not substantially impaired); Orbrecht v. National Gypsum Co., 105 N.W. 2d 143, 149 (Mich. 1960)(beds of Great Lakes alienable in exceptional circumstances); State Laws Bd. v. Heuicer, 548 P.2d 1323, 1325 (Or. App. 1976)(state can not grant away public right to use tidelands for commerce and navigation).

[7] 34 Miss. 21 (1857).

[8] Martin v. O'Brien, 34 Miss. 21, 36 (1857).

[9] 184 Miss. 202, 184 So. 44 (1938), *sugg. error overruled*, 185 So. 247 (1939).

[10] State *ex rel.* Rice v. Stewart, 184 Miss. at 219, 184 So. at 45.

owners established a commercial sand and gravel mining operation in the bayou.[11] Citing its ownership under the public trust doctrine, the state filed suit to enjoin the mining operations.[12]

In its opinion, the court restated its holding in *Martin* that the state holds lands under navigable tidal waters below mean high tide in trust for the people.[13] It then further defined the term "navigable" to include all waters subject to the ebb and the flow of the tide, regardless of navigability in fact.

> The phrase 'navigable river,' has a technical meaning in the Common Law. A river is navigable in the technical sense, as high up from its mouth as the tide flows . . . . Above that it may be a common highway, subject to the use of the public for navigation according to the common law acceptation of the term, but it is not technically a navigable river. The soil under a river which is navigable in the technical sense, does not belong to the riparian owners, but to the public.[14]

Noting that no sound policy reason exists for distinguishing ownership of beds beneath freshwater (which extends to the middle of the stream with a navigation easement in favor of the public) and tidal rivers, the court nonetheless restated its acceptance of the English common law public trust doctrine.[15]

As recently as 1986, in *Cinque Bambini v. State*,[16] the court affirmed this general rule, but with a curious line of reasoning. The case arose from a dispute over rights to oil and gas on approximately 600 acres of marshland in Hancock County.[17] For almost a century and a half, a succession of owners of the land in question had paid property taxes to the state. Private ownership was not questioned until 1977 when the state granted mineral leases throughout the area.[18] The leases contained assertions of state ownership, under the public trust doctrine, of sub-

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[11] *Id.*

[12] *Id.*

[13] *Id.* at 224, 184 So. at 47.

[14] *Id.* at 225, 184 So. at 47.

[15] *Id.* at 230, 184 So. at 50.

[16] 491 So. 2d 508 (Miss. 1986), *aff'd*, Phillips Petroleum Co. v. Mississippi, ___ U.S. ___, 108 S. Ct. 791 (1988).

[17] Cinque Bambini v. State, 491 So. 2d at 510.

[18] *Id.* at 511.

merged lands subject to the ebb and flow of the tide up to mean high-water mark, by virtue of the "ebb and flow" test.[19] The Cinque Bambini Partnership, contended however, that the public trust extends only to submerged tidelands that are "navigable-in-fact."[20]

In its reaffirmation of state ownership of tidelands up to the mean high tide line, regardless of actual navigability, the court virtually ignored the *Stewart* line of reasoning. Instead, it reanalyzed the issue in light of federal law.[21] This approach required the court to determine whether extension of the public trust doctrine to inland navigable waters by the United States Supreme Court in *The Genessee Chief*[22] in 1851 had resulted in a restriction of the "ebb and flow" test for public trust jurisdiction in tidal lands.[23] Drawing an analogy to navigable freshwaters, the Mississippi court stated that the trust applies to both the navigable and non-navigable portions of a freshwater waterway up to the high-water mark.[24] It then equated the "mean high tide" line with the "high-water" mark of a river.[25] Because the tidelands granted to Mississippi under the "equal footing" doctrine are those fronting the Gulf of Mexico — un-

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[19] *Id.* at 514. Utilizing the "ebb and flow" test, the public trust would be construed to include tidally influenced non-navigable waters. *Id.*

[20] *Id.* at 513.

[21] The court merely mentioned the *Stewart* holding in support of its own conclusion under the federal law analysis. *Id.* at 516. The court deemed the issue to be a federal question, as the federal government had title to the lands prior to statehood, and as the allocation of land to tide state, to private citizens, and to the public trust was governed by the "equal footing" doctrine. *Id.* at 513.

[22] 53 U.S. (12 How.) 443 (1851). *The Genesse Chief* case was precipitated by a collision between two vessels on Lake Ontario. The appellant contended that the federal court system did not have jurisdiction over the case, as admiralty and maritime jurisdiction "is limited to cases occurring upon waters within the ebb and flow of the tide." *Id.* at 447. The court examined the reasons for the initial grant of admiralty jurisdiction to the federal government, and determined that the same reasons extend to navigable streams and lakes. *Id.* at 453-54. Accordingly, the court held that admiralty jurisdiction encompassed navigable inland waters as well as those influenced by the tide. *Id.* Subsequent to this expansion of admiralty jurisdiction, the Supreme Court expanded the boundaries of the public trust to include navigable inland waters. *Cinque Bambini*, 491 So. 2d at 514.

[23] *Cinque Bambini*, 491 So. 2d at 513.

[24] *Id.* at 514.

[25] *Id.* at 514-15.

questionably a navigable body of water — the court reasoned that the trust therefore extends from the state's border on the Gulf to the mean high tide line.[26] Despite the strained reasoning of the opinion, the resultant holding is consistent with past decisions of the court.

2. *Ambulatory Boundaries*

Because coastal tidelands are a dynamic, constantly changing ecosystem, their geographic boundaries are "ambulatory," or mobile. Wetlands are created and destroyed regularly by both natural and man-made forces, described in legal terminology as accretion[27], reliction[28], and avulsion[29]. To what extent do the legal boundaries of trust land follow these changes? The Mississippi Supreme Court has taken the position that accretions that develop adjacent to the shore become the property of the upland owner.[30] The court justifies this holding on the theory that it protects an owner's littoral right of access to the water.[31] Title to noncontiguous fast lands that emerge from tidal waters, however, is held by the state in trust for the public in the same manner as submerged tidelands.[32] Accreted lands adjacent to an island belong to the owner of the island, even when such

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[26] *Id.* at 515-16. The court found further support for its conclusion in the fact that "tide" terminology has continued in use since *The Genessee Chief*, thus indicating that the "navigable waters" test is an extension rather than replacement of the "ebb and flow" rule. *Id.* at 515.

[27] "Accretion" refers to the "addition of portions of soil, by gradual deposition through the operation of natural causes, to that already in possession of owner." BLACK'S LAW DICTIONARY 36 (4th ed. 1957).

[28] "Reliction" is an "increase of the land by the permanent withdrawal or retrocession of the sea or a river." BLACK'S LAW DICTIONARY 1455 (4th ed. 1957).

[29] "Avulsion" is the "removal of a considerable quantity of soil from the land of one man, and its deposit upon or annexation to the land of another, suddenly and by the perceptible action of water." BLACK'S LAW DICTIONARY 173 (4th ed. 1957).

[30] H.K. Porter Co. v. Jackson County, 324 So. 2d 746, 750 (Miss. 1975); International Paper Co. v. Mississippi State Highway Dep't, 271 So. 2d 395, 398 (Miss. 1972); Harrison County v. Guice, 244 Miss. 95, 106, 140 So. 2d 838, 841-42 (1962).

[31] Harrison County v. Guice, 244 Miss. 95, 101, 140 So. 2d 838, 841-42 (1962).

[32] International Paper Co. v. Mississippi State Highway Dep't, 271 So. 2d 395, 398-99 (Miss. 1972). The court noted that the land mass belonged to the state when submerged as part of a state-owned bay floor, and apparently reasoned that elevation of the noncontiguous mass above the water surface did not merit review of title to the land. *Id.*

accretions meet the mainland.[33]

In 1962, the court was first presented the opportunity to determine whether lands that were once subject to the public trust could inure to the upland owner when artificially filled. In *Harrison County v. Guice*[34], the county filled shallow bottoms below mean high tide, as well as upland on Guice's property, in order to protect Highway 90 and the seawall that separated it from the Mississippi Sound.[35] The court found this to be an artificial accretion erected by "strangers to the upland title."[36] Such accretions, decided the court, become the property of the upland owner, even though the accretions were created at public expense and the submerged land that was filled to make the beach previously belonged to the state.[37] The court reached this conclusion by analogy to the principle that owners whose property adjoins tidelands cannot extend their lands by artificially reclaiming state-owned bottoms.[38] The court stated that protection of the littoral owner's right of access to the water is the reason for such a rule.[39]

A federal court opinion arising from the same controversy as *Guice* came to the opposite conclusion. In *United States v. Harrison County*,[40] The Fifth Circuit rejected the *Guice* holding, reasoning instead that Section 95 of the Mississippi Constitution of 1890 supersedes the common law doctrine of accretion.[41] Section 95 provides that "lands belonging to, or under the control of the state, shall never be donated directly or indirectly to private corporations or individuals."[42] Because of this provision, the court ruled, private upland owners cannot take ownership of for-

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[33] H.K. Porter Co. v. Jackson County, 324 So. 2d 746, 751 (Miss. 1975).

[34] 244 Miss. 95, 140 So. 2d 838 (1962).

[35] *Id.* at 839. Work was financed with a combination of federal and county funds to remedy an erosion problem associated with the original construction of the seawall. *Id.* The county secured an easement from Ms. Guice, but only 50' wide. *Id.* Ms. Guice owned approximately 175-250 feet south of Highway 90 at the time of granting of easement and emplacement of the sloping beach. *Id.*

[36] *Id.* at 842.

[37] *Id.*

[38] *Id.*

[39] *Id.*

[40] 399 F.2d 485 (5th Cir. 1968).

[41] *Id.* at 491.

[42] MISS. CONST. art. IV, § 95.

merly submerged lands.[43] This reasoning allowed specific performance of a contract entered into in 1951 by the federal government and Harrison County, in which the government awarded 1.3 million dollars to the state of Mississippi for the construction of 17 miles of beach in Harrison County. In exchange for such public funds, the county agreed that the beaches would be made available to the public. The court granted public access to such beaches for sunbathing, recreation, and other uses appropriate to a sand beach, so long as such use did not unreasonably interfere with the littoral rights of the upland owners.[44]

These conflicting decisions leave the status of ownership of the man-made beaches on Mississippi's coast and the viability of the common law doctrine of accretions in doubt. Section 95 of the Mississippi Constitution of 1890 is not mentioned in the *Guice* opinion, so it is unclear whether that issue was raised and considered. Dicta in the Mississippi Supreme Court's latest public trust case suggest acceptance of the *Guice* holding.[45] As development pressures on Mississippi's coast increase, conflicts between public and private rights on the beach are bound to arise. Therefore, it is likely that the court will be called upon to resolve the two opinions.

If the court were to accept the *Guice* holding in a subsequent case, it would create a no-win situation for the governing body charged with overseeing man-made beaches, upland owners, and the public. The court could reconcile *Guice* with the *Harrison County* decision, however, by applying the common law doctrine of implied dedication. The dedication doctrine makes it possible for a landowner either to transfer full ownership of his land to the public or to grant an easement to the public for certain uses.[46] To be legally enforceable, two elements

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[43] *Harrison County*, 399 F.2d at 491.

[44] *Id.*

[45] *Cinque Bambini*, 491 So. 2d at 519. The court referred to the *Guice* opinion as support for the proposition that the deposit of alluvial soil upon the "margin of water" inures to the benefit of the owner of the shoreland. *Id.* This reference was made as part of a summary of the contours of Mississippi Law governing the title of coastal lands, and did not address the inconsistency presented by the *Harrison County* decision.

[46] "Dedication is the term applied to a transfer of the ownership of land or of a privilege to use it to the public for a public purpose." 6A POWELL, LAW OF REAL PROPERTY § 926 (1986).

must be present: an intent on the part of a property owner to dedicate and a valid acceptance by the public.[47]

An owner's intent to dedicate may be expressly given or implied from his failure to object to continued use of his property by the public.[48] It is crucial, though, that a non-expressed intention be clearly and unequivocally manifested. Also, acceptance may be either express or implied through formal action or use by the public.[49]

To date, application of the doctrine of implied dedication in Mississippi has been limited to roads and parks.[50] The test established by the court requires "long use for a specific public purpose, the discontinuance of which constitutes a violation of good faith to the public and to those who have acquired property with a view to the use contemplated by the dedication."[51] It seems clear that such a test can be met in relation to Mississippi's beaches. Members of the public have been using the beaches openly and without interference.[52] Because use need not be constant, it would be irrelevant that public use diminishes during the winter months. In many instances, counties are expending funds to maintain them. In addition, local governments routinely grant privilege licenses to beach vendors without ob-

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[47] *Id.* at § 926 (2).

[48] "An implied dedication may arise by operation of law from the acts and conduct of a landowner." *Id.*

[49] *Id.*

[50] *See, e.g.*, City of Louisville v. Hull, 292 So. 2d 177, 179 (Miss. 1974)(recognized implied dedication doctrine applicable to property owned by a municipality); Armstrong v. Itawamba County, 16 So. 2d 752, 757 (Miss. 1944)(recognized implied dedication of road which had been used by public and maintained with public funds for about twenty years); Harrison County v. Seal, 66 Miss. 129, 129, 5 So. 622, 622 (1889)(acceptance of dedication of road does not have to be express but can be inferred from public use); Kinnare v. Gregory, 55 Miss. 612, 620-21 (1878)(early recognition of implied dedication where court enjoined obstruction of highway by private party).

[51] City of Louisville v. Hull, 292 So. 2d 177, 179 (Miss. 1974).

[52] This writer knows of only two exceptions. First, formerly blacks were excluded from beaches which instigated the *Guice* and *Harrison County* decisions. More recently, a controversy has developed over public use of the beaches of Deer Island. Deer Island is a 500-600 acre island located in the Mississippi Sound, offshore from the coastal city of Biloxi. A private developer has attempted to restrict public access to all but a small portion of the island that is owned by the city of Biloxi. Prior to the developer's acquisition of the property, the public freely used the island for recreational purposes. As a result, an uneasy tension now prevails over public use of the island.

taining prior permission of adjacent landowners. Thus, it would be a violation of good faith to the public to discontinue such long use for public recreational purposes. The court has held continued use over a period of time, combined with maintenance at public expense, to be sufficient to find implied dedication of a road.[53] There is no reason that the result should differ when the issue is public use of a beach.[54]

The Court in *Cinque Bambini* answered affirmatively the question of whether public trust lands can be enlarged by the natural inland expansion of tidewaters.[55] The court reasoned that such a ruling is logically consistent with the principle of allowing private freshwater riparian landowners to benefit from accretions.[56] It specifically declined to rule on the issue of the status of trust lands that become fast lands through reliction.[57] It seems likely that such a situation would be treated in the same way as natural accretions to upland property. In both instances, tidewaters are replaced by land; the only difference is the manner in which the land is formed. If the policy reason for granting accretions to the upland owner is to protect such owner's right to access to the water, then the legal result should be the same.[58] However, as discussed above, section 95 of the Mississippi Constitution of 1890 could be interpreted to prevent

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[53] Armstrong v. Itawamba County, 16 So. 2d 752, 756-57 (Miss. 1944).

[54] Texas and California courts have recognized implied dedications of beaches. *See* County of Los Angeles v. Berk, 605 P.2d 381, 391 (Cal. 1980)(found implied dedication of beaches, slope, and bluff even though public thought property was private); Gion v. City of Santa Cruz, 465 P.2d 50, 57-58 (Cal. 1974)(once implied dedication complete, subsequent owner cannot prevent public use); Seaway Co. v. Attorney General, 375 S.W. 2d 923, 935-37 (Texas 1964)(found implied dedication of beach from mean low tide mark to seaward side of vegetation line).

[55] *Cinque Bambini*, 491 So. 2d at 519-20.

[56] *Id.* at 520.

[57] *Id.* at 519.

[58] The court in *Guice* hints at this result. It defines "accretion" broadly to include lands created by the gradual recession of water, which is technically known as "reliction". If the court understood reliction to be a subset of accretions, then relicted lands are logically treated the same as accreted lands. "Ordinarily, accretion means the gradual deposit of alluvial soil upon the margin of the water or the gradual recession of the water." *Guice*, 244 Miss. at 99, 140 So. 2d at 842. The court appears to be confused on this matter, though. The court in *Cinque Bambini* cites *Guice* for this proposition, but on the next page says reliction has never been decided by the court. *Cinque Bambini*, 491 So. 2d at 519.

this result.

Avulsions, on the other hand, have been held not to affect title or boundaries.[59] According to the court, this principle holds true whether the avulsion is natural or artificially induced, such as through dredging operations.[60] Therefore, when an upland owner dredges his land to create a boat slip, he retains ownership of that part of his property that becomes "wet" as a result.

Alienation of Public Trust Lands

Historically, the Mississippi Supreme Court has been erratic in its position regarding the extent to which the state can divest itself of tidelands. Early in the history of Mississippi public trust case law, the court held in *Martin v. O'Brien* that state-owned tidelands could "by grant, become private property, or the subject of an exclusive private right."[61] Following this reasoning, the court upheld the right of a municipality to grant to an individual who was not a riparian landowner the exclusive right to erect, operate, and maintain a public wharf in the Mississippi Sound.[62] Furthermore, the decision allowed a riparian landowner to erect a private wharf in public trust waters adjacent to his property.[63] The wharf was to be used for landing and shipping his own property, but not that of others.[64] However, in keeping with its assertion that the state could freely alienate lands below the high water mark, the court stated that the right to construct a private wharf could be taken away by the legisla-

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[59] *Cinque Bambini*, 491 So. 2d at 520. This proposition has been well-settled law in the United States as regards fresh water since 1904 when, in the case of Missouri v. Nebraska, 196 U.S. 23 (1904), the United States Supreme Court stated: "It is equally well settled that where a stream which is a boundary, from any cause suddenly abandons its old and seeks a new bed, such change of channel works no change of boundary; . . . This sudden and rapid change of channel is termed, in law, avulsion." Missouri v. Nebraska, 196 U.S. at 35.

[60] *Cinque Bambini*, 491 So. 2d at 520. "Put more broadly, under the laws of this state, neither artificially created water courses, inlets, slips, marinas and the like, nor physical improvement or alteration made thereto, become a part of the public trust, even thought they become tidally affected." *Id.*

[61] Martin v. O'Brien, 34 Miss. 21, 36 (1857).

[62] *Id.* at 38.

[63] *Id.* at 37.

[64] *Id.*

ture.[65] This decision indicated that such a right was not incident to the ownership of property bordered by tidelands.[66]

The ability of the state to grant fee simple title in public trust tidelands to private parties for private purposes was restricted seventy-five years later in *Money v. Wood*.[67] Here, the plaintiffs challenged the state's right to sell submerged lands between Deer Island and the mainland in Biloxi "for the purpose of constructing and erecting an artificial island, with hotels, boulevards, and residences for the private purposes of the appellants."[68] The sale was made pursuant to a statute that permitted the state land commissioner to sell certain public lands.[69] In finding the sale void, the Mississippi Supreme Court held that the state, as trustee, could not dispose of these lands, if to do so would be inconsistent with the purpose for which the trust exists.[70] Unfortunately, the court shed no light on the exact nature of this purpose. It stated further that section 81 of the Mississippi Constitution of 1890[71] supports the court's decision to align itself with those states holding that trust lands cannot be conveyed in fee to private owners for private purposes.[72] The court specifically recognized, however, that some states allow conveyance of fee title to public trust lands, even if doing so deprives the people of future control of these lands.[73]

This decision directly contradicts the court's holding in *Martin*, which was not alluded to in the opinion. While it is unclear why the court chose to ignore *Martin*, two important events arguably influenced its decision. First, between the *Mar-*

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[65] *Id.* at 36.

[66] *Id.* ". . . and it also follows that the position . . . that the owners of lands lying on the seashore have the right to build wharves for their own use into the sea adjoining the front of their lands, and cannot be deprived of that right by grant under legislative authority, cannot be maintained." *Id.*

[67] 152 Miss. 17, 118 So. 357 (1928).

[68] *Id.* at 24, 118 So. at 358.

[69] *Id.* The statute provided for the sale of "all accretions of land not the subject of private ownership, and particularly those accretions near the mouth of the Pascagoula River . . . at the same price as swamp and overflow lands . . . ." 1906 Miss. Laws 2919.

[70] *Money*, 152 Miss. at 27, 118 So. at 359.

[71] MISS. CONST. art IV. § 81. "The Legislature shall never authorize the permanent obstruction of any of the navigable waters of the State. . ." *Id.*

[72] *Money*, 152 Miss. at 27, 118 So. at 359.

[73] *Id.*

tin and *Money* decisions, the United States Supreme Court, in *Illinois Central Railroad v. Illinois*[74], had occasion to interpret the right of states to alienate public trust lands. The issue in *Illinois Central* concerned a grant by the Illinois legislature of over 1,000 acres of shoreline on Lake Michigan. The United States Supreme Court held the grant invalid under the public trust doctrine, ruling that such a grant would be permissible only if it did not result in public uses being subjected to private interest.[75]

Second, section 81 of the Mississippi Constitution of 1890, which prohibits the permanent obstruction of the navigable waters of the state, was adopted after the *Martin* decision. The court stated that the purpose of this section was to align Mississippi with those states that follow the holding of *Illinois Central.*[76] The court then cited an earlier decision that interpreted the statute involved in *Money* to be applicable only to rural lands valuable for timber, pasturage, or agriculture.[77] Relying on this definition, the court construed the statute narrowly to exclude tidelands, which the court classified as water rather than land.[78]

These contrasting opinions could also indicate a change in philosophy regarding the scope of the state's trust duties. The court's language in *Martin* demonstrates a strong conviction that the legislature has an unrestricted right to alienate trust lands to private persons for private purposes. By contrast, the *Money* court indicated that such a divesture by the legislature would be a breach of its duty to the public, even absent section

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[74] 146 U.S. 387 (1892).

[75] *Id.* at 452-53.

[76] *Money*, 152 Miss. at 29, 118 So. at 359. "It seems to us that section 81 of the Constitution was adopted by the Constitutional Convention for the purpose of aligning this state with the line of authorities which hold that the state cannot convey in fee such rights to private owners for private purposes. We are satisfied that this section of the Constitution applies to the waters here involved, and to the lands under such waters, and that such waters are regarded as navigable." *Id.*

[77] *Id.* In Huber v. Freret, 135 Miss. 235, 103 So. 3 (1925) the court rejected application of the statute to the grant of land located in the heart of downtown Jackson. *Huber*, 135 Miss. at 239, 103 So. at 4. In doing so the court limited application of tide statute to "those public lands which are usually bought and sold by acreage - in other words, property commonly known as rural lands . . . ." *Id.*

[78] *Id.* at 30, 118 So. at 359-60.

81 of the Mississippi Constitution of 1890. "It is unnecessary to decide whether it would be possible for the state to sell such lands in fee independent of a constitutional restriction. It certainly would be a breach of duty for the legislature to do so . . . ."[79]

Thirty years later the court, in *Giles v. City of Biloxi*[80] displayed another shift in attitude regarding private development of tidelands. Although *Giles* dealt not with the public trust doctrine, but with a provision of the Mississippi constitution prohibiting the granting of state lands to private persons except by general law,[81] the language of the court presages its next public lands alienation case. *Giles* concerned an effort to develop Deer Island, a nearshore barrier island, into a resort. To facilitate such development, the Mississippi legislature, by a local and private law, established the Biloxi Bridge and Park Commission and empowered it to lease and sell certain reclaimed submerged lands around Deer Island. After holding this legislation unconstitutional under Section 90(u), the court stated that it was "keenly aware of the public interest involved and the desirability of developing the island. This decision does not mean that this court will not look upon any future plan for developing Deer Island with as much favor as the constitution and laws of the state permit."[82]

The court kept its word eight years later in *Treuting v. Bridge and Park Commission*[83] when it was called upon to rule upon the ability of the legislature to authorize, pursuant to general legislation, fee simple transfer of title to tidelands. In 1960 the Mississippi legislature passed a statute authorizing coastal municipalities to establish bridge and park commissions who were authorized to purchase islands and submerged lands in the Mississippi Sound.[84] After purchase, a commission could reclaim and sell them if they were "unnecessary for park or recreational

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[79] *Id.*, 118 So. at 359.

[80] 237 Miss. 35, 112 So. 2d 815 (1959).

[81] MISS. CONST. art IV, § 90 (u).

[82] *Giles*, 239 Miss. at 44, 112 So. 2d at 824.

[83] 199 So. 2d 627 (Miss. 1967).

[84] *Id.* at 629.

purposes for the benefit of the public, or for other public use."[85] Subsequently the state conveyed to the Biloxi Bridge and Park Commission fee simple interest in approximately 150 acres of submerged lands in the Mississippi Sound adjacent to the island.[86] The Park Commission had already purchased 12 ½ acres of land, with accretions, on the west end of Deer Island.

At issue was the ability of the state to convey fee simple interest in public trust tidelands to private parties for private purposes. In reaching an affirmative answer, the court considered two sub-issues: (1) did the proposed project violate section 81 of the Mississippi Constitution of 1890 prohibiting the obstruction of navigable waters, and (2) did the sale of submerged lands violate the common law public trust doctrine?[87]

As to the "obstruction" issue, the court found that filling of the submerged lands in question would have no tangible effect upon the right of the public to use navigable waters of the state.[88] In fact, navigation would be aided because existing channels in Biloxi Bay would be widened and deepened to provide the necessary fill material.[89] Therefore, section 81 was not violated.[90] This position represented a retreat from an earlier holding of the court that section 81 is applicable to all tidal waters regardless of actual navigability.[91] It is unclear what legal principle this distinction is based upon. The court offhandedly relegated to dicta the holding that the purpose of section 81 was to prohibit the alienation of tidelands for private purposes.[92] The court's language implies that incremental obstructions will be permitted when overall navigation in the state is furthered.[93]

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[85] *Id.*

[86] *Id.* The Biloxi Park Commission intended to undertake a project for development of the island as a means of expansion for the city. The island was to be connected to the mainland by a bridge. Approximately 27% of the island was to be devoted to public uses, and 50 to 53% to residential, commercial and resort development. *Id.* at 630-31.

[87] *Id.* at 631-33.

[88] *Id.* at 631.

[89] *Id.* at 632.

[90] *Id.* at 632. "The context of section 81 is directed toward free navigation. It has nothing to do with the alienation of mud flats and waters not suitable for navigation in fact, or the sale of submerged lands." *Id.*

[91] Culley v. Pearl River Indus. Comm'n, 234 Miss. 788, 108 So. 2d 390 (1959).

[92] *Treuting*, 199 So. 2d at 632.

[93] "The filling of the submerged lands in question will have no tangible effect on the

Next, the court discussed the issue of whether such a sale was in contravention of the public trust doctrine. In upholding the sale, the court found that the legislature was justified in authorizing the sale of these lands to private individuals as "incident" to the overall public interest and purpose.[94] Because no substantial interference with the original purposes of the trust would occur, the trust was not violated.[95] "If the totality of the development promotes the public interest in general, the incidental private ownership of individual lots does not negative [sic] the comprehensive public purpose."[96] The public purposes served by the development, as recognized by the court, were "commerce, tourism, recreation, and accommodation of an expanding population."[97] The court concluded that the proposed development was not inconsistent with formerly established trust purposes, i.e., navigation, fisheries, and commerce.[98]

Six years later, the court modified the stance it had taken in *Treuting*. *International Paper v. Mississippi State Highway Department*[99] arose from the Highway Department's proposed construction of Interstate 10 across property on Lowry Island that International Paper claimed to have acquired by mesne conveyances in 1967.[100] International Paper and its predecessors had paid taxes on the property since 1884, when it was first sold pursuant to an act of the legislature.[101] The land in question was subject to the ebb and flow of the tide in 1817 when Mississippi entered the Union. In addition, some of the land had formed by accretion from the floor of the bay. The issue before the court was whether the legislature had authority to convey in fee simple the marshlands and accreted lands on Lowry Island for private benefit.

The court first addressed the issue of accretion. It found the

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right of the public in waters of the state for fishing, boating and related endeavors." *Id.*

[94] *Id.* at 633.

[95] *Id.*

[96] *Id.*

[97] *Id.*

[98] *Id.*

[99] 271 So. 2d 395 (Miss. 1972).

[100] *Id.* at 397.

[101] *Id.* at 396-97.

Guice holding inapplicable because in *Guice* the accreted land was adjacent to the upland owner's property where as in the case at bar the accreted land was noncontiguous.[102] Unable to find authority applicable to the title of noncontiguous fast lands which had emerged from tidal waters, the court decided, with no discussion of its rationale, that such lands were owned and held by the state in trust for the public in the same manner as submerged tidelands.[103]

The court then turned to the ability of the legislature to convey title to private parties. As could be expected, International Paper relied upon *Treuting* to support its claim. But the court, in another philosophical about-face, characterized *Treuting* as an exception to the general rule prohibiting sale of trust lands.[104] Having thus limited the *Treuting* decision to its facts, the court was free to hold the 1884 sale invalid under the line of decisions following *Money*.[105]

How can the above cases be reconciled into a coherent state policy regarding the alienation of public trust tidelands? The following principles can be derived from the case law. First, the state is clearly prohibited from selling trust lands to private persons for private purposes. Arguably this principle is the reason that the *Treuting* court had to strain to find a "totality of public purpose" rationale for approving the sale of public lands for what was clearly private development. Second, the state may convey fee simple title to private persons if the conveyance is consistent with the public purposes of the trust and the sale is made pursuant to general legislation.[106] Purposes of the trust have evolved over time to include commerce and navigation,[107] fishing,[108] bathing, swimming, and other recreational activities,[109] and development of mineral resources.[110] The legislature

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[102] *Id.* at 398.

[103] *Id.* at 398-99.

[104] *Id.* The court distinguished *Treuting* as being exceptional since it involved special legislation directed to a particular area, and more importantly, the resulting public purpose substantially outweighed the public interest. *Id.*

[105] *Id.*

[106] *See supra* notes 87-98 and accompanying text.

[107] *Martin*, 34 Miss. at 37.

[108] *Stewart*, 184 Miss. at 231, 184 So. at 50.

[109] *Trueting*, 199 So. 2d at 632-33.

[110] *Id.* at 633.

has expanded these to include the preservation of wetlands in their natural state.[111] However, because the court has for the most part rejected efforts to privatize public tidelands, case law provides little guidance on how the state can assure such consistency.

One writer has argued that private ownership of public trust lands for private purposes need not be antithetical to public rights in such lands. He therefore questions the court's reluctance to allow divesture.[112] He suggests that the public interest can be protected when public land is sold by imposing a public trust easement on the property.[113] He further advocates that in limited circumstances, such as when land is incapable of public use, it should be subject to sale free of the trust.[114] Although his proposal has some logical appeal and has precedent, this outlook ignores one of the most important purposes of the trust — protection of resources contained in public lands. As a matter of policy, private ownership is a poor way to guarantee this protection. Without extensive land-use regulation and enforcement, it is unlikely that a private owner will consistently make decisions concerning property that sufficiently weigh the public's interest. In addition, such regulation is rarely welcomed by private landowners.

A better approach would be to prohibit totally the disposition of public tidelands in fee simple to private parties. The state already has extensive regulatory powers that are well-adapted to accommodating the needs of private parties and the public in coastal resources. The Coastal Wetlands Protection Law[115] and accompanying regulations incorporated in the Mississippi Coastal Program[116] establish a permit system for certain activities that are detrimental to the wetland ecosystem. The

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[111] MISS. CODE ANN. § 49-27-3 (Supp. 1987).

[112] Comment, *The Mississippi Public Trust Doctrine: Private and Public Rights in the Coastal Zone*, 46 MISS. L.J. 84, *passim* (1975).

[113] *Id.* at 111.

[114] *Id.* at 112.

[115] Coastal Wetlands Protection Law, MISS. CODE ANN. § 49-27-1 (Supp. 1987).

[116] Wetlands Management, Mississippi Coastal Program Ch. 8, § 2 (Rev. 1983)(administrative rules, regulations, and procedures adopted to further aims of Coastal Wetlands Protections Law) [hereinafter Wetlands Management Regulations].

law is designed to further a legislatively declared public trust policy of preserving the "natural state of the coastal wetlands and their ecosystems and to prevent the despoliation and destruction of them, except where a specific alteration of specific coastal wetlands would serve a higher public interest in compliance with the public purposes of the public trust in which coastal wetlands are held."[117]

The Coastal Program was envisioned by its creators as a vehicle for protecting valuable coastal resources without hampering the state's potential for economic growth. This is accomplished by regulating growth away from more fragile coastal resources while encouraging economic development in areas more capable of accommodating it with the least amount of alteration of the wetlands ecosystem. Under the permit review system in the Coastal Program, activities of private parties will be allowed to encroach into public tidelands only so long as the public interest is accommodated.[118] It provides private owners a

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[117] MISS. CODE ANN. § 49-27-3 (Supp. 1987).

[118] Wetland Management Regulations, *supra* note 116. The rules and regulations regarding wetlands management were adopted to carry out state policies as announced in Mississippi Code sections 49-27-3 and 57-15-6. Wetlands Management Regulation, *supra* note 116, at Ch. 8 § 2 (I)(A).

> It is declared to be public policy of this state to favor the preservation of the natural state of the coastal wetlands and their ecosystems and to prevent the despoliation and destruction of them, except where a specific alteration of specific coastal wetlands would serve a higher public interest in compliance with the public purposes of the public trust in which coastal wetlands are held.

MISS. CODE ANN. § 49-27-3 (Supp. 1987)

> In recognition of the Coastal Zone Management Act of 1972, as amended, the [Marine Resources] Council is directed to prepare and implement a coastal program that establishes guidelines and procedures pursuant to the following goals:
> (a) To provide for reasonable industrial expansion in the coastal area and to insure the efficient utilization of waterfront industrial sites so that suitable sites are conserved for water dependent industry;
> (b) To conserve the resources of the coastal area for this and succeeding generations in accordance with the public policies expressed in sections . . . 49-27-3 . . .,. Mississippi Code of 1972; . . .

MISS. CODE ANN. § 57-15-6(1)(Supp. 1987)

In deciding whether or not a permit should be granted authorizing a regulated activity, it is the state's position that "[p]reference is to be given to preserving the coastal wetlands in their natural state, and that the burden of demonstrating the higher public interest in altering wetlands rests with the party proposing the alteration." Wetlands Management Regulations, *supra* note 116, at Ch. 8, § 2(I)(E).

means of using public trust lands without having to obtain fee simple title, while simultaneously protecting the public interest. This obviates the need to transfer ownership to private parties.

PROTECTED PUBLIC AND PRIVATE USES

1. Common Law

An uneasy tension exists between public and private uses in protected nearshore waters. In 1904, the court in *Barataria Canning Co. v. Ott*[119] had the opportunity to distinguish between the rights of littoral/riparian[120] owners and the public in natural resources in the waters adjacent to their property.[121] The case involved leasing oyster beds off waterfront property on the Mississippi Sound. Ott, a riparian owner, leased waterfront property to Barataria. Subsequently, the Harrison County Board of Supervisors granted Barataria the right to plant and harvest oysters from the water bottoms adjacent to the leased property. Ott later conveyed the lot to Barataria, with the proviso that Barataria would cancel and surrender the lease and pay Ott $6,000. The deed reserved in Ott the littoral and aquatic rights appurtenant to the property. The issue before the court was whether this reservation resulted in Ott having a property right in the oysters.

In its opinion, the court stated unequivocally that landowners abutting the Sound possess the same right as the public to fish and gather oysters from waters in front of their property.[122] Therefore, the right to harvest oysters was not a littoral right. The court then enumerated some rights incident to littoral ownership which include "the privilege of landing his boats, hauling his nets, the gathering of seaweed and shells, and taking sand from the beach between the high and low water marks."[123] Next,

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[119] 84 Miss. 737, 37 So. 121 (1904).

[120] Riparian owners are those whose land borders on a water course. BLACK'S LAW DICTIONARY 1192 (5th ed. 1979). Littoral owners are those whose property borders on an ocean, sea, or lake. *Id.* at 842. The two terms are often used interchangeably.

[121] Barataria Canning Co. v. Ott, 84 Miss. at 752-54, 37 So. at 123-24.

[122] *Id.* at 752, 37 So. at 123.

[123] *Id.* at 752-53, 37 So. at 123. The court noted that some jurisdictions protect, in addition, a right to erect wharves, piers, and bathhouses in the water fronting property. *Id.* The *Martin* court expressly denied such rights as incident to littoral ownership in

the court acknowledged the right of the county to lease to private parties submerged lands for a term of 25 years for the purpose of oyster farming.[124] The lessee, a non-riparian owner, acquired a vested private property right in the oysters that he "banked, planted, and cultivated" within the lease area.[125] Because this right arose from a legislative rather than common law littoral power, Ott could not acquire the right to the oysters through reservation in the deed.

The public, including the littoral owner, presumably retained common rights such as fishing and navigation in the leased area, so long as doing so did not unreasonably interfere with the lessee's lawfully conducted oyster business.[126]

Fifty years elapsed before the court again dealt with littoral rights. *Crary v. State Highway Commission*[127] involved property that Crary owned adjacent to the Bay of St. Louis in the Mississippi Sound. By statute, he had been granted the privilege of planting and gathering oysters and erecting bathhouses and other structures in front of his land for a distance of 500 yards from the low water mark.[128] Later the state constructed a bridge across the Bay of St. Louis. As a result, Crary was unable to exercise these privileges. He claimed that such action amounted to a taking of his property for public use without just compensation.[129] The state claimed that since it had merely imposed an additional public use on property already set aside for a public purpose no unconstitutional taking had occurred.[130]

The court concurred with the state's position, holding that

Mississippi. *Martin*, 34 Miss. at 36. The court also intimated that littoral rights are so inextricably bound to the property that they are legally incapable of separation. *Barataria Canning Co.*, 84 Miss. at 753, 37 So. at 123.

[124] *Barataria Canning Co.*, 84 Miss. at 753-54, 37 So. at 124.

[125] *Id.* at 754, 37 So. at 124.

[126] "They [littoral owners] had the right to use the beach and water front of their property in any manner which would not interfere with the business of their lessee carried on upon the leased premises." *Id.*

[127] 219 Miss. 284, 68 So. 2d 468 (1954).

[128] *Id.* at 287-88, 68 So. 2d at 468.

[129] *Id.* at 288, 68 So. 2d at 469. "Private property shall not be taken or damaged for public use, except on due compensation being first made to the owner or owners thereof, in a manner to be prescribed by law . . ." MISS. CONST. art. III, § 17.

[130] *Crary*, 219 Miss. at 289, 68 So. 2d at 469.

the state simply granted a revocable license.[131] To hold otherwise, the court said, would be a violation of the state's constitutional and common law public trust responsibilities.[132] Because Crary held only a revocable license, no private property was taken. Therefore, the right to farm oysters and erect structures in waters adjacent to one's property is not a littoral right. Even though the rights at issue in this case were granted by statute, the court's language is sufficiently broad to include other littoral rights that attached at common law.

> The damage sustained results not from a taking of the riparian owners' privileges in the Bay, but from the lawful exercise of the state's power to which this property has always been subject, and which has always been owned by the state as trustee for the people. It is this primary and superior title of the state as trustee for the people which frees the state from any liability to appellants in constructing this bridge. When the state implemented its title and responsibilities as trustee, for the public, by constructing this bridge, it was exercising its paramount power and superior title in the waters of and soil under the Bay of St. Louis, rather than taking the private property of anyone.[133]

Later that same year, in *Xidis v. City of Gulfport*,[134] the court dealt with the extent of state power to authorize a project that obstructed a littoral owner's access to water.[135] Xidis owned and operated a restaurant on U.S. Highway 90 bordering the Mississippi Sound. He had spent large sums of money advertising the restaurant as being on the beach. However, the city of Gulfport's development of a small craft commercial harbor in front of his restaurant as part of an expansion plan for the Port of Gulfport allegedly obstructed the restaurant's waterfront view, as well as deprived him of other littoral rights such as ac-

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[131] *Id.* at 293, 68 So. 2d at 471. "Code Sec. 6066, when construed consistently with these decisions (*Money* and *Stewart*) and Const. sec. 81, simply granted to appellants a revocable license of the privilege to plant and gather oysters and to build bathhouses and other structures." *Id.* (parenthetical added).

[132] *Id.*

[133] *Id.*

[134] 221 Miss. 79, 72 So. 2d 153 (1954).

[135] *Id.* at 91, 72 So. 2d at 158.

cess to the water, boating, bathing, and fishing. He brought suit, claiming an illegal taking of his littoral property rights.[136]

First, the court ruled that the city of Gulfport was acting under properly delegated legislative authority when it approved and began construction of the harbor.[137] The city therefore possessed the same rights as the state as trustee of the submerged lands in question.[138] Citing *Crary*, the court held that rights of riparian owners in public trust tidelands are subordinate to rights of the state.[139] Because the commercial harbor was a legitimate additional use of public trust lands, designed to benefit the public, no taking occurred.[140] The court indicated, however, that future erection of commercial structures in the harbor could result in actionable injury to Xidis.[141] Arguably, then, the state is limited in uses of public trust lands that cause detriment to an adjacent upland owner. Unfortunately, the court gave no guidance on what must be considered in balancing public and private rights.

Eighteen years later, the court in its *Guice* decision took a strong stand in favor of littoral rights of a property owner. As mentioned earlier, *Guice* arose over public use of beach property in Harrison County.[142] The beach had been constructed with the use of public funds and was intended for public use. The Guices claimed, however, that, as a result of the doctrine of artificial accretion, the beach belonged to them. In its opinion, the court recognized littoral property rights of navigation, boating, swimming, fishing, exclusive access to the water, and the right to accretions to upland property.[143] It intimated that state actions which would result in loss of one of these rights would be a tak-

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[136] *Id.* at 93, 72 So. 2d at 159. The court rejected that argument on the basis that commercial harbor use was important to the port and therefore was an aid to navigation rather than an obstruction of navigable waters, and that "[t]he right of access of a riparian owner may not prevail as against the state or its grantee in the exercise of the lawful use or purpose . . . ." *Id.* at 90-91, 72 So. 2d at 158.

[137] *Id.* at 91, 72 So. 2d at 158.

[138] *Id.*

[139] *Id.*

[140] *Id.* at 93, 72 So. 2d at 159.

[141] *Id.* at 95, 72 So. 2d at 160.

[142] *Guice*, 244 Miss. at 100-03, 140 So. 2d at 839-40.

[143] *Id.* at 106-07, 140 So. 2d at 842.

ing of private property, requiring the payment of just compensation.[144]

The court distinguished *Crary* and *Xidis* primarily on the grounds that the plaintiffs in those cases did not seek damages for interference with access to the water.[145] This distinction, although not persuasive, is not surprising. It should be recognized that the issue in the *Guice* case was as much civil rights as public trust. Because it arose over the use of Harrison County beaches by blacks at a time when the civil rights movement was in its infancy, it is arguable that the result is also a reflection of the segregationist mores of the time.

Five years later in *Treuting* the court reiterated its stand in *Guice*. "Moreover, there is a private trust associated with the submerged bottoms running in favor of the upland owner whose lands border the line marked by the mean high tide line."[146] According to the court, this private trust, presumably consonant with common law littoral rights, includes an unobstructed view and access to the water.[147] The precedential value of this case is questionable, however. First, the court's statements on the public trust are dicta. Second, as stated earlier, the case was restricted to its facts by the court in *International Paper.*

As can be seen from the above discussion, the Mississippi Supreme Court has not developed a consistent position on the relative common law rights of public and private citizens in their use of nearshore public trust waters. The Mississippi legislature, however, has attempted to reconcile public and private interests in this area. These will now be examined.

2. *Statutory*

A national movement emerged in the early 1970s to reduce the growing loss of coastal wetlands to development pressures. Congress responded with passage of the Coastal Zone Management Act of 1972,[148] which provides coastal states with incen-

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[144] *Id.* at 107-08, 140 So. 2d at 842.

[145] *Id.* at 109, 140 So. 2d at 843.

[146] *Treuting*, 199 So. 2d at 633.

[147] *Id.* at 632-33 (quoting Hayes v. Bowman, 91 So. 2d 795, 799 (Fla. 1957)).

[148] Coastal Zone Management Act, 16 U.S.C. § 1451 (1987).

tives to manage their coastal areas through implementation of federally approved coastal zone management programs. During this period, the Mississippi legislature passed the Coastal Wetlands Protection Law of 1973.[149] The Act seeks to protect coastal wetlands by requiring permits for certain activities. Coastal wetlands are defined in the law to include all public trust tidelands located within Harrison, Hancock and Jackson counties.[150]

The public policy of the Act is to preserve wetlands, except when a specific alteration would serve a higher public interest.[151] The regulatory system established to carry out this policy is contained in the Mississippi Coastal Program.[152] It delineates a procedure for issuing permits for the following activities: (1) dredging any type of material from wetlands; (2) filling any kind of material either directly or indirectly, on or in the wetlands; (3) killing or materially damaging any flora or fauna on or in any coastal wetlands; (4) erecting on coastal wetlands any structure that materially affects the ebb and flow of the tide; and (5) erecting any structure on sites suitable for water-dependent industry.[153] In addition to identifying regulated activities, the Coastal Program includes a wetlands use plan, which divides coastal wetlands into five types of use districts: commercial, industrial, general, preservation, and special use. Within each district, only certain types of activities are eligible for a wetlands permit.[154]

Permits are issued by the Bureau of Marine Resources, following approval by the Commission on Wildlife Conservation.[155] In considering an application, the Bureau examines several aspects of a project. First, the proposed project's effect on the public interest is evaluated by reviewing applicable legislative or

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[149] MISS. CODE ANN. § 49-27-3 (Supp. 1987).

[150] MISS. CODE ANN. § 49-27-5(a) (Supp. 1987).

[151] MISS. CODE ANN. § 49-27-3 (Supp. 1987).

[152] *See supra* note 118.

[153] MISS. CODE ANN. § 49-27-5 (Supp. 1987).

[154] Wetlands Management Regulations, *supra* note 116 at Ch. 8, § 2(IV).

[155] MISS. CODE ANN. § 57-15-6 (Supp. 1987). The Coastal Wetlands Protection Law and Coastal Program are administered by the Mississippi Commission on Wildlife Conservation through the Bureau of Marine Resources, a subdivision of the Department of Wildlife Conservation. Where the Bureau is referred to hereinafter, it should be understood to include the authority of the Commission, unless the context clearly indicates otherwise.

judicial definitions of public interest. Also reviewed are applicable coastal use and special management area plans, precedent-setting effects of the proposed activity, the national interest, and public comments. Second, the degree of ecosystem alteration is assessed by analyzing reasonably anticipated, direct and indirect effects of the project on the ecosystem. Also evaluated are the extent to which adverse impacts can be avoided through modifications, and the extent to which natural scenic qualities will be preserved. Third, economic benefits of the proposed project are evaluated by examining the extent to which adverse impacts can be avoided through modifications, safeguards or other conditions; the availability of alternative sites; and the extent to which a waterfront location is necessary for the proposed use.[156]

When the Mississippi legislature passed the Wetlands Law, it exempted certain activities, areas, and entities from all but the public policy provision of the statute.[157] Included in these exemptions are, among others, activities that occur within five feet of private property; recreational activities that do not adversely affect wetlands; shellfishing when otherwise legally permitted; normal maintenance and repair of bulkheads, piers, and roads; and exercise of riparian rights by a landowner.[158] Each of these exemptions involves in some way littoral rights of upland owners.

This provision has been a source of confusion and some controversy as some have claimed that it constitutes a blanket exemption from the Act.[159] The Bureau has interpreted this section to remove the exempted entities and activities from the formal permit process only. According to the procedure set out in the Coastal Program, the Bureau must be notified of any exempted activities which would otherwise be regulated. Within

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[156] In cases where unauthorized work affecting wetlands occurs, an after-the-fact permit may be applied for. MISS. CODE ANN. § 49-27-51 (Supp. 1987). The Bureau must issue such a permit if the work was conducted in accordance with the public policy of the Wetlands Law and the pertinent provisions of the Coastal Program. MISS. CODE ANN. § 49-27-51 (Supp. 1987). This determination is made by utilizing the same factors used in reviewing other permits. *Id.*

[157] MISS. CODE ANN. § 49-27-7 (Supp. 1987).

[158] *Id.*

[159] C. JARMAN & C. MILLS, A LEGAL ANALYSIS OF MISSISSIPPI'S COASTAL WETLANDS MANAGEMENT PROGRAM 16-23 (1984).

thirty days of such notification, the Bureau is required to make a finding that the proposed activity is in fact excluded and is in accordance with the public policy of preserving wetlands. The analysis used by the Bureau in making this decision is the same as for a permitted activity.[160] Absent such a finding, the project cannot go forward.[161]

How, then, do the Coastal Wetlands Protection Law and Coastal Program affect the legal status of common law littoral rights? As can be seen from the above discussion, the court has recognized littoral rights. These include landing boats, hauling nets, gathering seaweed and shells, and taking sand from the beach between the high and low water mark. In addition, a littoral owner has the right to an unobstructed view, access to the water, and use of the water for navigation, boating, swimming, and fishing. Finally, accretions to upland property are granted to the owner as littoral rights.[162] Note, though, that the broad public policy statement of the Act creates a presumption that favors public rights over private rights in wetlands when the conflict would result in damage to or destruction of tidelands. Such a presumption does not clearly exist at common law.[163]

Although private littoral rights are subordinate to public rights, the law and accompanying regulations recognize and accommodate these rights by exempting some activities associated with them from the formal permitting process. Arguably this language is broad enough to include common law as well as statutorily granted littoral rights. In addition, it expands an upland owner's property rights to include the construction and maintenance of piers, bathhouses, and similar structures that don't significantly interfere with the flow of the tides. The law appears to have no affect on the exercise of littoral rights that do not alter wetlands, such as boating, swimming, fishing, and viewing the water. In addition, it does not change the law with respect to granting accreted lands to the upland owner as the law applies only in publicly-owned wetlands. Other rights, to the extent that

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[160] Wetlands Management Regulations, *supra* note 116 at Ch. 8, § 2(II)c.

[161] *Id.*

[162] *See supra* notes 34-45 and accompanying text.

[163] *See supra* notes 120-147 and accompanying text.

they adversely affect tidelands, are now subject to the review procedure established in the Coastal Program.

CONCLUSION

The public trust doctrine in Mississippi continues to be a fluid one. Because of the erratic nature of the court's rulings, it is difficult to discern a coherent and consistent policy behind the doctrine. One reason for this is that the court has never expressed a clear sense of purpose for the public trust concept.

As stated earlier, the public trust doctrine developed originally to preserve in the public rights to fishing and navigation in tidal waters.[164] Since then, the goals of the doctrine have broadened into a duty to manage all natural resources included in the trust in a manner that protects the public's right to use them.[165] In other words, the trust mandates an ecological ethic in coastal decision-making that maintains an environmentally sound tidelands ecosystem. The legislature has codified this duty in the Coastal Wetlands Protection Law which is based upon a principle of preserving coastal wetlands in their natural state.[166]

Keeping this duty in mind, the following principles should evolve in Mississippi's public trust jurisprudence. First, the state should be prohibited from granting fee simple interest in public trust lands to private parties. Second, public trust lands should remain the property of the state, even if they lose their character as wetlands. Third, exclusive private use of public trust lands should be viewed with skepticism, and allowed only when the likelihood of conflict with public use of the land is minimal and the environment will not be significantly degraded by the private use. This includes decisions regarding upland activities that have a high degree of potential for degrading the tideland environment. Fourth, sufficient provisions should be made to guarantee public access to tidelands and their resources.

Such an interpretation of the public trust doctrine is consistent with the goals expressed by the Mississippi legislature in

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[164] *See supra* notes 120-126 and accompanying text.

[165] Jarmon, *The Public Trust Doctrine in the Exclusive Economic Zone*, 65 OR. L. REV. 1, 26 (1986).

[166] MISS. CODE ANN. § 49-27-3 (Supp. 1987).

the Coastal Wetlands Protection Law and Coastal Program to balance private development with the need to protect the resources of the coastal environment.

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COMMENTS

RESOLVING THE CONFLICT BETWEEN CHAPTER 13 OF THE BANKRUPTCY CODE AND THE FREE EXERCISE CLAUSE — IN RE GREEN: A STEP IN THE WRONG DIRECTION

Will a man rob God? Yet you are robbing me. But you say, "How have we robbed thee?" In tithes and contributions. You are cursed with a curse, for you are robbing me, the whole nation of you. Bring the whole tithe into the storehouse, so that there may be food in my house, and test me now in this, says the Lord of hosts, if I will not open for you the windows of heaven, and pour out for you a blessing until there is no more need.

MALACHI 3:8-10

I. Introduction

The religion clauses of the first amendment to the Constitution set forth the proposition that "Congress shall make no law respecting an establishment of religion, or prohibiting the free exercise thereof . . . ."[1] Religion in the United States has seen a tremendous outgrowth of diversity[2] since the First Congress adopted this broad ver-

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[1] U.S. Const. amend. I. The U.S. Supreme Court has held the religion clauses to be fully applicable to the states as well as the federal government through the fourteenth amendment. *See* Everson v. Board of Educ., 330 U.S. 1, 15 (1947)(holding establishment clause applicable); Cantwell v. Connecticut, 310 U.S. 296, 303 (1940)(applying free exercise clause). *See generally* School Dist. of Abingdon Township v. Schempp, 374 U.S. 203, 215-16 (1963)(general discussion of court doctrine applying religion clauses to states and a listing of cases which have reaffirmed that doctrine).

[2] *See Developments in the Law — Religion and the State*, 100 Harv. L. Rev. 1606,

sion of the religion clauses from the many considered by the House and Senate in 1789.[3] This heterogeneity among American religious organizations produces a wide variety of religious beliefs and activities, many of which have challenged a broad range of state and federal laws in courtrooms throughout the country.[4] In *In re Green*,[5] the United States Bankruptcy Court for the Western District of Michigan became the first court to examine a conflict between tithing within a chapter 13 plan under the Bankruptcy Code[6] and the establishment and free exercises clauses of the first amendment to the United States Constitution.[7]

Tithing,[8] as a means of financial support for religious purposes, can be traced back many centuries before the birth of Christ.[9] Up

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1613-19 (1987)[hereinafter *Developments*](discussion of religious diversity in America from colonial times to modern day religions). There are over 1200 different religious bodies available to worshipers in twentieth century America, including numerous churches, sects and religious movements. *Id.* at 1613. Despite this wide variety, the religion of the United States is mainly influenced by Protestantism, Catholicism, and Judaism. *Id.* at 1613 n.8 (citing YEARBOOK OF AMERICAN CHURCHES, 1981, at 236 (C. Jacquet ed. 1983)).

[3] *See* Laycock, *A Survey of Religious Liberty in the United States*, 47 OHIO ST. L.J. 409, 411-12 (1986)(overview of different versions of religion clauses considered and rejected by First Congress).

[4] *See* Garvey, *Free Exercise and the Values of Religious Liberty*, 18 CONN. L. REV. 779, 783 (1986)(religious convictions have made free exercise questions out of social security laws, tax laws, minimum wage laws); Note, *Religious Exemptions Under the Free Exercise Clause: A Model of Competing Authorities*, 90 YALE L.J. 350, 351-52 (1980)(religious claims have been lodged against driver's license photograph requirements, compulsory education requirements, narcotics statutes, civil rights statutes, labor laws, bigamy laws).

[5] 73 Bankr. 893 (Bankr. W.D. Mich. 1987).

[6] 11 U.S.C. §§ 1301-1330 (1982 & Supp. IV 1986).

[7] In re Green, 73 Bankr. 893, 893 (Bankr. W.D. Mich. 1987). *But cf.* In re Gaukler, 63 Bankr. 224 (Bankr. D.N.D. 1986)(court in analyzing chapter 7 debtor petition to determine whether it should be dismissed due to substantial abuse allowed debtors to tithe ten percent of income to church but did not analyze case under establishment or free exercise clauses).

[8] Tithing may generally be defined "as the giving of a tenth of the annual produce or other income for the support of a particular religious ministry." Horner, *The Christian and the Tithe*, in RESOURCE UNLIMITED 176, 178 (W. Hendericks ed. 1972). The word "tithe" derives from the Anglo-Saxon *teothe* and means the tenth. *Id.* A tithe has been legally defined as a tenth part of some specific thing. In re Witney's Estate, 162 Cal. 2d 860, 329 P.2d 104, 108 (Cal. App. 1958). *See also* Schreckergost v. Gospel Tabernacle, 188 Pa. Super. 652, 149 A.2d 542, 543 (1959)("tither" is one who contributes ten percent of earnings to the church).

[9] *See generally* Horner, *supra* note 8, at 178 (ancient peoples of Chaldea and Egypt offered to their gods a tenth of the increase of their lands in the valleys of the Euphrates and the Nile); Paschall, *Tithing in the New Testament*, in RESOURCE UNLIMITED 167, 167

through the Revolutionary War in America, and at the time of the framing of the first amendment, tithing and voluntary support of the clergy and church were regularly practiced by American worshipers.[10] As churches in the United States began to face financial difficulties, tithing to the church became widely accepted as a religious fund-raising tool.[11] In modern day American religion, the importance of tithing to religious organizations is a controversial subject.[12] Many believers feel that tithing one's income for religious purposes is an integral part of religious faith and is required of every believer.[13] Others feel tithing is an unnecessary practice which should be viewed only as an outdated custom and not as a mandatory religious obligation.[14] Despite these differences of opinion, the practice of tithing as an act of religious faith and as a means of supporting organized religion is still very much alive in the United States[15] and is widely followed by many religious denominations.[16]

This Comment focuses on the bankruptcy court's decision in *Green* in relation to cases of the United States Supreme Court involving the free exercise clause. Part II of this Comment discusses the facts and holding of *Green* and sets forth the rationale of the bankruptcy court in that case. In Part III, the previous effect of including a tithe in a chapter 13 bankruptcy plan is examined with respect to applicable bankruptcy law on the subject. Part IV examines judicial review under the free exercise and establishment clauses and determines whether the bankruptcy court correctly decided *Green* in light of the competing

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(W. Hendricks ed. 1972)(practice of ancient peoples paying one-tenth to the King existed among Greeks, Romans, Babylonians, Egyptians, and Hebrews). *See also* Wester, *The Christian and the Tithe*, in RESOURCE UNLIMITED 158, 160 (W. Hendricks ed. 1972)(tithing has been traced back to 2100 B.C. in Babylon and 1300 B.C. in Greece).

[10] *See generally* D. JOHNSON, THE TITHE: CHALLENGE OR LEGALISM? 48-49 (1984)(early tithing in America directed toward the poor, the support of ministers, and minister's widows); Wester, *supra* note 9, at 162-63 (general discussion of tithing in the early years of the United States).

[11] *See* JOHNSON, *supra* note 10, at 53 (noting that the tithe has been an important fund-raising technique throughout the twentieth century)(citing SALSTRAND, THE STORY OF STEWARDSHIP IN THE UNITED STATES OF AMERICA 13-14 (1956)).

[12] Wester, *supra* note 9, at 164.

[13] *Id. See also* BURKETT, YOUR FINANCES IN CHANGING TIMES 88 (1975)(supporting proposition that every believer should tithe as a minimum act of faith).

[14] Wester, *supra* note 9, at 164. *See also* BURKETT, *supra* note 13, at 135 (many believe tithing is a legalism derived from the Old Testament of the Bible and is not binding on the modern day religious believer).

[15] Wester, *supra* note 9, at 164.

[16] *See* Horner, *supra* note 8, at 177 (nearly all major denominations support tithing as means of supporting organized religion and evidencing one's faith in God).

interests which are present in a free exercise case. This Comment concludes that the bankruptcy court reached an incorrect result in *Green*, and that the court analyzed the case in a manner which failed to take into account the substantial harm sustained by innocent third parties as a direct result of the court's accommodation of the debtor's free exercise of religion.

II. *In Re Green*

A. *Factual Background*

The debtors, Stephen R. Green and Norma J. Green, are members of the Lively Stone Apostolic Church of God.[17] In February of 1987, the debtors filed a petition for chapter 13 protection[18] in the United States Bankruptcy Court for the Western District of Michigan.[19] Included in the monthly budget of the debtor's chapter 13 plan[20] was a provision which indicated that Norma Green would make a donation of $140 per month as a tithe to her church.[21] The State of Michigan, one of the Greens' unsecured creditors,[22] objected to confirmation of the plan.[23] While the sincerity of Mrs. Green's religious convictions was not

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[17] National Law Journal, June 22, 1987, at 7, col. 1. The Lively Stone Apostolic Church of God is located in Kalamazoo, Michigan. *Id.* The church belongs to the Pentecostal Assemblies of the World denomination. *Id.* The sentiment of the church is that members are not pressured to commit to tithing. *Id.* Instead, the church teaches its members "what was practiced in the Scriptures by believers." *Id.*

[18] Chapter 13 of the Bankruptcy Reform Act of 1978 is entitled *Adjustment of Debts of an Individual with Regular Income*, 11 U.S.C. §§ 1301-1330 (1982 & Supp. IV 1986).

[19] *Green*, 73 Bankr. at 893.

[20] All chapter 13 debtors are required to file a creditor repayment plan according to their income and expenses with the bankruptcy court. 11 U.S.C. § 1321 (1982). After giving the appropriate notice to interested parties, the court will hold a hearing on confirmation of the plan. 11 U.S.C. § 1324 (1982 & Supp. IV 1986). At this time, any party in interest may object to confirmation of the plan. *Id. See also* In re Estus, 695 F.2d 311, 314 n.4 (8th Cir. 1982)(although creditors cannot reject chapter 13 plan, they can object to confirmation of plan at confirmation hearing).

[21] *Green*, 73 Bankr. at 893. At the time of the filing of the chapter 13 plan, Mr. and Mrs. Green had a joint net monthly income of $1,650. National Law Journal, June 22, 1987, at 7, col. 1. The Greens filed a three-year plan which would pay $96.33 per month to their creditors and a $140 per month tithe to their church. *Id.*

[22] *Green*, 73 Bankr. at 893.

[23] *Id.* The Michigan Attorney General's Office represented the State in the matter. National Law Journal, June 22, 1987, at 7, col. 1. The Greens owed the State of Michigan for about $2,795 in unpaid student loans. *Id.* The Greens' other creditors made no objection to the plan. *Id.* Under the plan proposed by the debtors, the creditors would recoup 17 percent of their debts as opposed to 50 percent if the Greens did not tithe. *Id.*

challenged,[24] the state did contend that court confirmation of a chapter 13 plan which permitted tithing would give the Bankruptcy Code a construction condoning the religious practice of tithing in violation of the establishment clause.[25] The state argued that such an interpretation of the Bankruptcy Code would favor religions which obligate their followers to tithe over religions that do not, and would favor those debtors over debtors who either are not required to tithe under the precepts of their religion or who do not practice any religion at all.[26]

B. The Bankruptcy Court's Opinion

In reviewing the state's claim that confirmation of the Greens' chapter 13 plan would violate the establishment clause, the bankruptcy court applied the three-prong test of *Lemon v. Kurtzman*[27] enunciated by the United States Supreme Court in 1971.[28] The first prong of the *Lemon* test — that the statute being considered have a secular legislative purpose[29] — was found by the *Green* court to have been satisfied by the Bankruptcy Code.[30] The court stated that it was not the intent of Congress to enact the Bankruptcy Code to provide disguised aid to religious institutions and the Code's secular purpose would not be altered by confirmation of the debtors' plan.[31]

Turning to the second element of the *Lemon* standard, which requires that the principal or primary effect of the statute in question be

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[24] *Green*, 73 Bankr. at 893. Neither did the state choose to contest the reasonableness of the amount of the tithe. *Id.* at 894.

[25] *Id.*

[26] *Id.*

[27] 403 U.S. 602 (1971). The "test" to determine whether a law offends the establishment clause was extracted from Supreme Court cases previous to *Lemon* and crystallized within the Court's decision in that case. *Id.* at 612-13. The first two prongs of the test were taken from Board of Education v. Allen, 392 U.S. 236, 243 (1968), and were stated by the court in *Lemon* as providing: "[f]irst, the statute must have a secular legislative purpose; second, its principal or primary effect must be one that neither advances nor inhibits religion . . .;" *Lemon*, 403 U.S. at 612. The third prong was derived from Walz v. Tax Commission, 397 U.S. 664, 674 (1970), and stated in *Lemon* as: "finally, the statute must not foster 'an excessive entanglement with religion.' " *Lemon*, 403 U.S. at 613.

[28] *Green*, 73 Bankr. at 894.

[29] *Id.*; *Lemon*, 403 U.S. at 612. The Court found that Congress enacted the bankruptcy laws to relieve honest debtors from oppressive financial burdens and to allow such debtors a new start without undue concern over "the obligations and responsibilities consequent upon business misfortunes." *Green*, 73 Bankr. at 894 (citing Local Loan Co. v. Hunt, 292 U.S. 234, 244 (1934)).

[30] *Green*, 73 Bankr. at 894.

[31] *Id.*

one that neither advances nor inhibits religion,[32] the court recognized that allowing the debtor to tithe under the plan was likely to advance the work of the church.[33] Nevertheless, the court found that since the proposed tithe was not a transfer of government funds to the church,[34] but was, rather, a transfer of Mrs. Green's property to her church, then confirmation of the plan would not defeat the secular effect mandate of the *Lemon* test.[35] The *Green* court reasoned that any extent to which the debtor's church was advantaged by confirmation was the result of the private choice of Mrs. Green which she had interposed between the court and her church.[36] According to the court, such a slight benefit to the church could not be judged to confer state approval on any particular religion or approval of religion in general.[37] The court also concluded that the third element of the *Lemon* test — that the statute not excessively entangle the state in religion[38] — was not violated by confirmation of the debtors' monthly budget.[39] Since the tithe would go directly from the debtor to the church, and the trustee in bankruptcy[40] was not involved in any way, the court ruled that excessive entanglement of church and state could not result from this situation.[41]

After disposing of the State of Michigan's establishment clause argument, the *Green* court proceeded to hold that not only was confirmation of the debtors' chapter 13 plan constitutional, but denial of chapter 13 relief solely because Mrs. Green wished to tithe to her church would violate the free exercise clause.[42] In reaching this conclusion, the

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[32] *Id.*; *Lemon*, 403 U.S. at 612.

[33] *Green*, 73 Bankr. at 894.

[34] *Id.* The *Green* court reasoned that if these funds were not tithed to the church, they would be used for either the debtors' living expenses or to pay the creditors, but under no circumstances would they go to the federal government. *Id.*

[35] *Id.* at 895.

[36] *Id.* at 894.

[37] *Id.* at 894-95 (citing Mueller v. Allen, 463 U.S. 388, 399 (1983)).

[38] *Green*, 73 Bankr. at 895; *Lemon*, 403 U.S. at 613.

[38] *Green*, 73 Bankr. at 895.

[40] *See* 11 U.S.C. § 1302 (1982 & Supp. IV 1986). A trustee is appointed by the court in all chapter 13 cases to advise the debtor, other than on legal matters, oversee the entire case, and assist the debtor in performance under the plan. *Id.*

[41] *Green*, 73 Bankr. at 895. The bankruptcy court, citing *Lemon*, noted that excessive entanglement had been defined by the Supreme Court as a "comprehensive, discriminating and continuing state surveillance." *Id.*; *Lemon*, 403 U.S. at 619. The *Green* court expressed the view that since the trustee in bankruptcy would not oversee how the tithe was used by the church, nor would he have to handle any part of the transaction between Mrs. Green and her church, then such state surveillance as defined by the Supreme Court in *Lemon* would be totally unnecessary. *Green*, 73 Bankr. at 895.

[42] *Green*, 73 Bankr. at 893, 895.

court relied primarily on *Hobbie v. Unemployment Appeals Commission of Florida*,[43] which reversed a denial of unemployment compensation to an employee who had been fired for refusing to work on Saturdays due to her religious beliefs.[44] The bankruptcy court emphasized that *Hobbie* stood for the proposition that an individual could not be forced to choose between obtaining benefits under the Bankruptcy Code or following the dictates of her religious convictions.[45] The court expressed the view that chapter 13 relief is at least as important a benefit as the right to unemployment compensation that the Supreme Court chose to protect in *Hobbie*.[46] Therefore, conditioning confirmation of the plan upon Mrs. Green ceasing to tithe would put pressure on her to violate her religious beliefs, and the state would have to show a compelling interest before such a burden on religion could be justified.[47] Absent such a compelling state interest, the court ruled that the debtors could not be denied confirmation of their chapter 13 plan solely because of Mrs. Green's decision to tithe to her church.[48]

III. Tithing Under Chapter 13 Bankruptcy

Although *In re Green* is the first Bankruptcy Court opinion to consider the relationship between tithing and the first amendment,[49] it is not the first such opinion involving the effect of tithing under the Bankruptcy Code. In pursuing an establishment clause claim to the ex-

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[43] 107 S. Ct. 1046 (1987).

[44] *Green*, 73 Bankr. at 895; Hobbie v. Unemployment Appeals Comm'n of Florida, 107 S. Ct. 1046, 1047 (1987). For a more detailed discussion of *Hobbie*, see *infra* notes 119-122 and accompanying text.

[45] *Green*, 73 Bankr. at 895-96. The bankruptcy court quoted *Hobbie* for the proposition that:

> Where the state conditions receipt of an important benefit upon conduct proscribed by a religious faith, *or where it denies such a benefit because of conduct mandated by religious belief, thereby putting substantial pressure on an adherent to modify his behavior and to violate his beliefs*, a burden upon religion exists. While the compulsion may be indirect, the infringement upon free exercise is nonetheless substantial.

Id. at 895 (emphasis in original); *Hobbie*, 107 S. Ct. at 1049 (quoting Thomas v. Review Bd. of the Indiana Employment Sec. Div., 450 U.S. 707, 717-18 (1981)).

[46] *Green*, 73 Bankr. at 895-96.

[47] *Id.* at 896 (citing *Hobbie*, 107 S. Ct. at 1049). The court stated that avoiding an establishment clause violation could possibly be such a compelling state interest, but such a violation was not present in this case. *Id.* The bankruptcy court noted that it could not think of any other compelling interest which would be present in this situation. *Id.*

[48] *Id.*

[49] National Law Journal, June 22, 1987, at 7, col. 1.

clusion of all alternative arguments,[50] the State of Michigan denied itself the opportunity to utilize applicable bankruptcy precedent which was favorable to its position.[51] As a result, the *Green* court was able to distinguish this law as irrelevant to the first amendment issues raised.[52] If, as this Comment suggests, the *Green* case was incorrectly decided by the bankruptcy court, then the bankruptcy tithing cases will control any possible future disposition in this case.[53] Therefore, a complete discussion of the treatment that an individual's desire to tithe has been afforded under the Bankruptcy Code is necessary.

Chapter 13 relief is available to individuals with income sufficiently stable and regular to allow them to make routine payments within a monthly budget.[54] In 1984, Congress passed the Bankruptcy

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[50] *See Green*, 73 Bankr. at 894. The state did not choose to contest the reasonableness or good faith of a chapter 13 plan which permitted tithing. *Id.* The state limited its argument to the theory that confirmation of a plan which permitted tithing is per se unconstitutional under the establishment clause. *Id.*

[51] *Id.* at 894 n.1. Since the state chose not to challenge the reasonableness of the Greens' chapter 13 plan, the court found that three cases which addressed tithing under the bankruptcy laws, In re Sturgeon, 51 Bankr. 82 (Bankr. S.D. Ind. 1985); In re Breckenridge, 12 Bankr. 159 (Bankr. S.D. Ohio 1980); and In re Cadogan, 4 Bankr. 598 (Bankr. W.D. La. 1980), distinguishable on grounds that they did not address the first amendment issues raised in *Green*. *Green*, 73 Bankr. at 894 n.1.

[52] *Green*, 73 Bankr. at 894 n.1. The state's decision to make an establishment clause argument, while ignoring supportive bankruptcy cases and doctrines on the tithing issue, is a questionable one at best. Unsecured creditors have standing to object to confirmation of a chapter 13 plan on the basis that the plan is not filed in good faith, or that the plan is not in the best interests of the creditors. *See* Lee, *Chapter 13 nee Chapter XIII*, 53 AM. BANKR. L.J. 303, 319 (1979)(discussion of possible objections to be made by unsecured creditors in chapter 13 proceeding). The state also overlooked the obvious objection that tithing could be considered "disposable income." *See* 11 U.S.C. § 1325(b)(1)(B) (1982 & Supp. IV 1986)(court may not approve plan unless all of debtor's disposable income is applied to payments under the plan). Disposable income is income which is not necessary for the reasonable living expenses of the debtor and dependants. 11 U.S.C. § 1325(b)(2)(A) (1982 & Supp. IV 1986). The *Green* court itself noted that if not for the devotion of Mrs. Green's tithe to her church, it would be considered disposable income under § 1325(b). *Green*, 73 Bankr. at 893-94. *See also Sturgeon*, 51 Bankr. at 84 (holding that a tithe of $140 per month to debtor's church is not a necessary living expense and constituted disposal income of the debtor). The state's motive in making a first amendment claim in light of proven alternative arguments remains unclear.

[53] The state has filed an appeal of the *Green* decision in the United States District Court in Kalamazoo, Michigan. National Law Journal, June 22, 1987, at 7, col. 3.

[54] *See* 11 U.S.C. § 101(29) (Supp. IV 1986)(definition of individual with regular income for purposes of chapter 13). *See generally* Butler & Morris, *Proceedings for the Adjustment of Debts of Individuals with Regular Income under the Bankruptcy Reform Act of 1978*, 28 EMORY L.J. 759, 761-63 (1979)(discussion of individuals eligible to file under chapter 13); Lee, *supra* note 52, at 303-05 (same). Individuals with regular income

Amendments and Federal Judgeship Act (BAFJA)[55] which revised certain sections of chapter 13, as well as the entire Bankruptcy Code.[56] One of the major changes implemented by the BAFJA is to require debtors to set aside all of their "disposal income" toward payment of creditors under the chapter 13 plan.[57] This provision of the amendments to chapter 13 allows bankruptcy courts the ability to deny confirmation of a debtor's plan which allots a portion of his or her income to tithing.[58]

In *In re Sturgeon*,[59] a chapter 13 debtor[60] included a $140 per month tithe in her monthly budget filed with the court.[61] One of the debtor's creditors[62] objected to confirmation of the plan alleging that the tithe was not a necessary living expense and should be paid to the creditors as disposable income.[63] Although acknowledging that tithing should be encouraged,[64] the court ruled that the debtor would have to commit the tithe to the repayment plan as a portion of her disposable income.[65] In a similar situation under chapter 7[66] of the Bankruptcy

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who are eligible for chapter 13 relief are limited to those with noncontingent, liquidated unsecured debts of less than $100,000 and noncontingent, liquidated secured debts of less than $350,000. 11 U.S.C. § 109(e) (1982).

[55] Pub. L. No. 98-353, 98 Stat. 333 (1984)(amending 11 U.S.C. §§ 101-151326 (1982 & Supp. IV 1986)).

[56] *Id.* For a well reasoned discussion of the possible impact of the Bankruptcy Amendments and Federal Judgeship Act on chapter 13 law and practice, see Corish & Herbert, *The Debtor's Dilemma: Disposable Income as the Cost of Chapter 13 Discharge in Consumer Bankruptcy*, 47 LA. L. REV. 47 (1986).

[57] 11 U.S.C. § 1325(b) (1982 & Supp. IV 1986). *See supra* note 52.

[58] *See* Corish & Herbert, *supra* note 56 at 74-76. The article expresses the view that such cases raise troubling questions concerning conflicts between a debtor fulfilling a perceived religious duty and attempting to obtain chapter 13 relief. *Id.* at 74. Published approximately eight months before the decision in *Green* was handed down, the authors proved to be slightly prophetic in their assessment.

[59] 51 Bankr. 82 (Bankr. S.D. Ind. 1985).

[60] The debtor was Patricia Ann Sturgeon. *Id.* at 82.

[61] *Id.* The debtor testified that she was "required" to donate ten percent of the "fruits of her labor" to the church. *Id.* at 83. The church stated the debtor's decision to tithe could be interpreted as a matter of conscience, rather than a law of the church. *Id.*

[62] The creditor was the Estate of Christopher Helmsing. *Id.* at 82. The decedent was killed in an automobile accident with the debtor. *Id.* at 83. The debtor pleaded guilty to driving under the influence of alcohol and received a five-year suspended sentence and restrictive probation. *Id.* The decedent's mother made the actual objections to confirmation of the plan. *Id.* at 82.

[63] *Id.* at 82-83.

[64] *Id.* at 83. The court expressed that reasons to encourage tithing were financial support of the church and the good to the community the church was able to do with such support. *Id.*

[65] *Id.* at 84. The court found that, given the tragic circumstances of the case, it

Code, the court in *In re Gaulker*[67] reached the opposite result. The *Gaukler* court found that debtors[68] who tithed $672.48 per month as required by their church[69] did not violate the substantial abuse provision of chapter 7.[70] Although the court emphasized that the debtors' willingness to make contributions they obviously could not afford "smacks of irresponsibility",[71] the decision to tithe was ultimately a matter between the debtors and God.[72] At least one legal commentator has noted that the distinguishing feature between *Sturgeon* and *Gaukler* could be the mandatory tithing obligation imposed by the debtors' church in *Gaukler*.[73]

A second rationale by which bankruptcy courts have shown themselves unwilling to allow tithing under a chapter 13 plan is because such a plan is deemed not to have been proposed in good faith.[74] *In re*

"would be a more just and more noble a gesture" to offer the $140 per month to the decedent's estate. *Id.* at 83-84. And, perhaps sanctimoniously, the court opined that it believed the church would understand and agree with its ruling. *Id.* at 84. In distinguishing *Sturgeon*, the court in *Green* noted that *Sturgeon* was unfortunate in that it represented a situation in which a judge was evaluating religious beliefs and practices without the guidance of first amendment case law. *Green*, 73 Bankr. at 894 n.1.

[66] 11 U.S.C. §§ 701-766 (1982 & Supp. IV 1986).

[67] 63 Bankr. 224 (Bankr. D.N.D. 1986).

[68] The debtors were Mr. and Mrs. David Gaukler. *Id.* at 225.

[69] *Id.* The debtors belonged to the Worldwide Church of God which mandated that its members donate ten percent of their income to the church, hold back an additional ten percent to use for expenses incurred in celebrating annual holy days and festivals, and to donate an additional ten percent in support of the needy every third and sixth year out of seven. *Id.* The debtors tithed in this manner despite providing in their chapter 7 schedule a budget of $280 per month for food to feed a family of six. *Id.*

[70] *See* 11 U.S.C. § 707(b) (1982 & Supp. IV 1986)(court may dismiss case filed by debtor if granting relief sought would constitute a substantial abuse of the provisions of chapter 7). *See also* In re Edwards, 50 Bankr. 933, 940 (Bankr. S.D.N.Y. 1985)(tithe of $100 per month did not constitute substantial abuse of provisions of chapter 7 under 11 U.S.C. § 707(b)).

[71] *Gaukler*, 63 Bankr. at 226.

[72] *Id.* The court stated:

> This court will not presume to know by what avenue one ought to seek salvation and recognizes in the eternal scheme of things material accomplishments count for naught. The debtors seem quite sincere in their conviction and this court is not so presumptuous as to inflict its personal views of religious and financial responsibility upon them.

Id.

[73] *See* Corish & Herbert, *supra* note 56, at 75 (*Sturgeon* leaves open the possibility that a different result might be warranted if a debtor's church required tithing as a condition of membership).

[74] *See* 11 U.S.C. § 1325(a) (1982 & Supp. IV 1986)(court shall confirm plan if it has been proposed in good faith and not by any means forbidden by law).

Breckenridge[75] involved an objection to confirmation of a chapter 13 plan which provided for a monthly $150 tithe.[76] Utilizing a sliding scale approach,[77] the court reasoned that the low percentage of repayment to the unsecured creditors,[78] contrasted with the donation of a significant portion of the debtors' income to their church,[79] would indicate that the good faith provision of chapter 13 had been violated.[80] Similarly, in a decision rendered three months after *Green*, the court in *In re Curry*[81] held that a debtor[82] who had $103 deducted from his paycheck as a tithe to his church[83] had not proposed his chapter 13 plan in good faith.[84] The *Curry* court noted that, although there were published opinions to the contrary,[85] a tithe as provided for in this case did not

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[75] 12 Bankr. 159 (Bankr. S.D. Ohio 1980).

[76] *Id.* at 159. The debtors were William and Shelia Breckenridge. *Id.* William Breckenridge had filed a petition in bankruptcy three years earlier and had received a discharge in February of 1978. *Id.* One of the Breckenridge's unsecured creditors objected to the plan claiming it had not been filed in good faith as required by § 1325(a)(3) of the Bankruptcy Code. *Id.*

[77] *Id.* at 160. The *Breckenridge* court followed the sliding scale approach taken in In re Cook, 3 Bankr. 480 (Bankr. S.D. W. Va. 1980). The scale proposed in *Cook* requires a court to inquire into the previous discharges a debtor has received under chapter 13. *Id.* at 486. If the time since a prior discharge is relatively short, then the debtor should be required to repay a higher percentage. *Id.* Conversely, if the length of discharge is not relatively short, then a lesser percentage could meet the good faith requirement. *Id. See generally*, Note, *Bankruptcy: Good Faith and the Zero Payment Plan in Chapter 13*, 69 Ky. L.J. 327, 351-55 (1981)(listing and general discussion of cases involving good faith issue under chapter 13).

[78] *Breckenridge*, 12 B.R. at 160. The court found that the plan proposed by the debtors would allow the unsecured creditors a repayment of ten percent of their outstanding debts, as opposed to over 70 percent repayment if the church tithe was included in the plan. *Id.* at 159-60.

[79] *Id.* at 160. The court emphasized that it did not hold church tithes in disfavor, but felt that the debtors should contribute as much as possible to the repayment of creditors, while leaving tithing to a time when the debtors could better afford it. *Id.*

[80] *Id. Cf.* In re Cadogen, 4 Bankr. 598, 599-600 (Bankr. W.D. La. 1980)(although not specifically addressing good faith issue, court ruled that debtor would have to reduce other expenses in order to continue tithing under chapter 13 plan in light of stingy manner in which creditors were being treated).

[81] 77 Bankr. 969 (Bankr. S.D. Fla. 1987).

[82] The debtor was Michael F. Curry, an ordained minister employed as a teacher by a church. *Id.* at 969.

[83] *Id.* The $103 withheld from the debtor's salary as a voluntary payroll deduction was paid to the church. *Id.* The debtor did not claim that he was required by the church to withhold this money from his check. *Id.* The court noted that the tithe represented almost half of the debtor's disposable income. *Id.*

[84] *Id.*

[85] *Id.* at 970. The bankruptcy judge did not specify which cases had reached an opposite result. *Id.* It is presumable that the court was referring to the recent decisions

constitute a reasonably necessary living expense and, as such, the confirmation of the plan would be denied as violative of good faith.[86] In the view of the court, good faith at least required a debtor to include all of his disposable income in the chapter 13 plan for the benefit of his creditors.[87] The *Curry* court emphasized that any other result would, in effect, require the creditors to contribute to the chosen charity of the debtor.[88]

IV. Chapter 13 Bankruptcy and the Religion Clauses of the First Amendment

Although the conflict in *In re Green* arose in the context of the establishment clause, the bankruptcy court's opinion has its greatest impact in the free exercise area. As a result, this Comment pays special attention to the free exercise concerns of the *Green* decision. *Green* breaks no new ground in establishment clause jurisprudence and merely applies settled doctrine. As such, the analysis of the establishment clause will be limited to a discussion of the inherent conflicts between the two religion clauses which are exposed in the bankruptcy court's opinion and the effect the court's establishment clause holding has on the free exercise concerns raised by *Green*.

A. Background of the Free Exercise Clause

The United States Supreme Court did not establish the parameters of the free exercise clause through a gradual case by case analysis.[89] Instead, in *Reynolds v. United States*,[90] the Court's first free ex-

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in *Green* and *Gaukler*. The *Curry* court also acknowledged that Official Form 10, authorized by Bankruptcy Rule 9009, provides a space for a chapter 13 debtor to list "religious and other charitable contributions" in their budget. *Curry*, 77 Bankr. at 970. The court stated the view that the official forms did not override the Bankruptcy Code and did not constitute judicial precedent that a chapter 13 debtor could impose a religious contribution upon his creditors. *Id.*

[86] *Curry*, 77 Bankr. at 970. The debtor, after learning of the court's conclusions of law, elected under 11 U.S.C. § 1307(a) (1982) to convert the proceedings to a chapter 7 liquidation case. *Curry*, 77 Bankr. at 970.

[87] *Curry*, 77 Bankr. at 970. The court noted that the plan proposed by the debtor only amounted to a 26 percent payment of unsecured creditors without interest. *Id.* at 969.

[88] *Id.* at 970. The court indicated that it did not believe such a result was contemplated by the Bankruptcy Code, nor did the court feel it had the discretion to allow such a result to be achieved. *Id.*

[89] *See* Pepper, *Reynolds, Yoder, and Beyond: Alternatives for the Free Exercise Clause*, 1981 Utah L. Rev. 309, 317 (instead of a gradual case by case development of doctrine, Court interpreted free exercise in drastic fashion in very first decision).

[90] 98 U.S. 145 (1878).

ercise decision established a rigid standard for subsequent courts to follow.[91] In upholding a bigamy statute against a free exercise challenge,[92] the *Reynolds* court held that although laws could not "interfere with mere religious beliefs and opinions, they may with practices."[93] Thus, the Court created a strict dichotomy between religious beliefs, over which the government had no control, and religiously motivated conduct, over which the government was permitted a strong measure of control.[94]

The Supreme Court consistently adhered to this distinction between belief and action over the next 85 years.[95] Then, in 1963, free exercise doctrine took an abrupt turn in *Sherbert v. Verner*.[96] *Sherbert* involved a Seventh-Day Adventist who was discharged by her employer for refusing to work on Saturday.[97] The South Carolina Employment Security Commission refused to award her unemployment compensation on the grounds that her failure to find suitable work resulted in disqualification.[98] The *Sherbert* court found that the Commission's ruling forced the appellant:

> . . . to choose between the precepts of her religion and forfeit-

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[91] *See Developments*, *supra* note 2, at 1706 (court sustained this standard over next eight decades); Note, *General Laws, Neutral Principals, and the Free Exercise Clause*, 33 VAND. L. REV. 149, 150 (1980)(Reynolds established rigid dichotomy between belief and action).

[92] Reynolds v. United States, 98 U.S. 145, 162 (1878). The defendant, a member of the Mormon Church, had been charged with bigamy after entering a second marriage. *Id.* The defendant testified that church doctrine imposed a duty on male members to practice polygamy. *Id.* at 161. The defendant contended that he had a free exercise right to be exempted from the statute. *Id.* at 162.

[93] *Id.* at 166.

[94] *Id.* at 164. Chief Justice Waite stated that government was able to reach religious actions "which were in violation of social duties or subversive of good order." *Id.* In Cantwell v. Connecticut, 310 U.S. 296 (1940), the Supreme Court further explained the belief/action distinction. The Court noted that the first amendment embraces two concepts: "freedom to believe and freedom to act. The first is absolute but, in the nature of things, the second cannot be. Conduct remains subject to regulation for the protection of society." *Id.* at 303-04.

[95] *See Developments*, *supra* note 2, at 1706 (Court sustained belief/action dichotomy over next eight decades). *See also* Marcus, *The Forum of Conscience: Applying Standards Under the Free Exercise Clause*, 1973 DUKE L.J. 1217, 1220 (effect of this position is that Supreme Court did not expressly resolve a major free exercise claim in favor of individual and against state prior to 1963).

[96] 374 U.S. 398 (1963).

[97] *Id.* at 399. The appellant testified that Saturday was the Sabbath Day of her faith. *Id.* The sincerity of appellant's religious beliefs was not questioned. *Id.* at 399 n.1.

[98] *Id.* at 401.

> ing benefits, on the one hand, and abandoning one of the precepts of her religion in order to accept work, on the other hand. Governmental imposition of such a choice puts the same kind of burden upon the free exercise of religion as would a fine imposed against appellant for her Saturday worship.[99]

The Court found that the indirect burden on appellant's free exercise of religion could not be tolerated.[100] In determining whether a state could constitutionally infringe the religious practices of an individual, the *Sherbert* court developed a three part analysis.[101] After an initial showing that a challenged state action impairs a complainant's religious freedom, the burden then shifts to the state to demonstrate it has a compelling interest which justifies such a burden on religion.[102] In addition, the state must show that there is not a less restrictive means of furthering that interest.[103]

The *Sherbert* balancing test was reaffirmed nine years later in *Wisconsin v. Yoder*.[104] *Yoder* involved three members of the Amish religion[105] who were fined for refusing to send their children to school until they reached sixteen years of age as mandated by Wisconsin law.[106] In sustaining the parents' free exercise claim, the Supreme Court held that legitimate claims to free exercise could only be overbalanced by those compelling interests of the highest order.[107] In a case similar to *Sherbert*,[108] the Court in *Thomas v. Review Board of the*

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[99] *Id.* at 404.

[100] *Id.* at 409.

[101] *Id.* at 406-07.

[102] *Id.* at 406.

[103] *Id.* at 407.

[104] 406 U.S. 205 (1972).

[105] The defendants were Jonas Yoder and Wallace Miller, members of the Old Order Amish religion, and Adin Yutzy, a member of the Conservative Amish Mennonite Church. *Id.* at 207.

[106] *Id.* The state's compulsory school attendance law required citizens to send their children to public or private school until they reached the age of sixteen. The children, Freida Yoder, Barbara Miller, both aged fifteen, and Vernon Yutzy, aged fourteen, were all taken out of school by their parents after having graduated from their eighth grade public school. *Id.* at 207 n.1. The defendants believed that their children's attendance at high school was contrary to the Amish religion and could endanger their salvation and that of their children. *Id.* at 209. The state stipulated that the religious beliefs of respondents were sincerely held. *Id.*

[107] *Id.* at 215.

[108] *See* Note, *Constitutional Law — Freedom of Religion — State's denial of unemployment benefits to Jehovah's Witness who quit armaments production job for religious reasons violates first amendment's free exercise clause*, 59 U. DET. J. URB. L. 217, 223 (1982)(*Thomas* is closely analogous to decision in *Sherbert*).

Indiana Employment Security Division[109] addressed the same issue of whether a free exercise violation exists when unemployment compensation benefits are denied to an individual due to a practice of his religion.[110] Applying the balancing test of *Sherbert* and *Yoder*, the Court found that where receipt of an important state benefit is conditioned on conduct prohibited by religious faith, which puts meaningful pressure on an individual to violate his or her beliefs, then a substantial burden on the free exercise of that individual's religion exists.[111]

Recently, the Supreme Court seemed to retreat from its broad standard of free exercise accommodation in *Bowen v. Roy*.[112] In *Roy*, a Native American challenged a federal statute that required parents to provide the Social Security number for their children before receiving certain welfare benefits.[113] The parent testified that he believed use of his child's Social Security number would serve to rob her of her spirit.[114] In rejecting the parent's claim, three members of the *Roy* Court[115] distinguished free exercise claims in which a regulation only "indirectly and incidentally" called for a choice between securing governmental benefits and following religious beliefs.[116] The *Roy* opinion maintained that such a regulation would be upheld if it was shown to

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[109] 450 U.S. 707 (1981).

[110] *Id.* at 709. The petitioner, a Jehovah's Witness, terminated his employment following transfer to a department which produced turrets for military tanks. *Id.* The religious beliefs of the petitioner precluded him from working on the production of war materials. *Id.* The Indiana Employment Security Division denied petitioner unemployment compensation benefits ruling his termination was not based on good cause as defined by the Indiana unemployment compensation statute. *Id.* at 712.

[111] *Id.* at 717-18. The bankruptcy court in *In re Green* cited this proposition from *Thomas*. *See supra* note 45 and accompanying text.

[112] 106 S. Ct. 2147 (1986). *See Developments*, *supra* note 2, at 1710 (Court's opinion in *Roy* seems to signal retreat from strict scrutiny standard for regulations attacked under free exercise clause).

[113] Bowen v. Roy, 106 S. Ct. 2147, 2147 (1986). The parent, Stephen J. Roy, refused to comply with the requirement of the Aid to Families with Dependent Children program and the Food Stamp program, which mandated that Social Security numbers of the members of the household be provided as a condition of receiving benefits. *Id.* at 2149-50.

[114] *Id.* at 2150. Roy, a Native American descended from the Aberaki Tribe, argued that it was his religious belief that use of the number would violate his daughter's uniqueness of person and spirit and would prevent her from achieving greater spiritual power. *Id.*

[115] Chief Justice Burger wrote the opinion of the Court, in which he was joined in Part III by only Justices Powell and Rehnquist. *Id.* at 2149.

[116] *Id.* at 2155. Part III of the *Roy* opinion expressed the view that the balancing test applied in *Sherbert*, *Yoder*, and *Thomas* was not appropriate in this situation. *Id.* at 2156.

be a "reasonable means of promoting a legitimate public interest."[117] Applying this relaxed standard, *Roy* held that using Social Security numbers was a reasonable means by which to prevent fraudulent claims within the welfare system and, consequently, that this interest outweighed the free exercise claim.[118]

A majority of the Court expressly rejected this lower standard of free exercise review the following year in *Hobbie v. Unemployment Appeals Commission of Florida*.[119] In a factual situation essentially identical to that of *Sherbert* and *Thomas*,[120] the *Hobbie* court[121] emphatically reaffirmed the proposition that substantial infringement on free exercise "must be subjected to strict scrutiny and could be justified only by proof by the State of a compelling interest."[122]

B. Free Exercise Analysis of In Re Green

Despite the emergence of an alternative free exercise standard in *Roy*, it is obvious that the *Sherbert* balancing test is considered by a majority of the current United States Supreme Court to be controlling in situations where governmental legislation or action conflicts with religiously motivated conduct.[123] Therefore, in order to determine the correctness or incorrectness of the decision rendered by the bankruptcy court in *In re Green*, the free exercise analysis initiated by the court must be examined in light of the three part balancing test articu-

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[117] *Id.* at 2156.

[118] *Id.* at 2155-57. In a strongly worded dissent, Justice O'Connor argued that the test advocated by Part III of the *Roy* opinion had "no basis in precedent and regulates a serious first amendment value to the barest level of minimal scrutiny . . . ." *Id.* at 2166. O'Connor noted that five members of the court had indicated in separate opinions that *Sherbert* and *Thomas* controlled the outcome of the case. *Id.* at 2167.

[119] 107 S. Ct. 1046 (1987).

[120] *Id.* at 1047-48. The appellant, Paula Hobbie, was discharged from her job for refusing to work Friday evenings and Saturdays. *Id.* Hobbie stated that her beliefs as a Seventh-Day Adventist would not allow her to work on her Sabbath. *Id.* at 1047. The Florida Department of Labor and Employment Security denied unemployment compensation benefits to Hobbie on the grounds that her refusal to work required shifts constituted work related misconduct. *Id.* at 1048. The Unemployment Appeals Commission of Florida upheld the denial of benefits based on the "less rigorous" standard applied in *Roy*. *Id.* at 1049.

[121] Justice Brennan wrote the majority opinion in which he was joined by Justices White, Marshall, Blackmun, O'Connor and Scalia. *Id.* at 1047.

[122] *Id.* at 1049.

[123] *See supra* note 121. It seems that the reemergence of the alternative free exercise standard articulated in *Roy* is unlikely any time in the near future. Of the three justices who joined in urging lower scrutiny for particular free exercise claims, only current Chief Justice William Rehnquist remains on the Court.

lated in *Sherbert* and its progeny.[124]

Under the first portion of the analysis, an initial showing must be made that a challenged state action impairs the religious freedom of an individual.[125] This showing is clearly made in *Green*. Under several constructions of chapter 13 of the Bankruptcy Code, the practice of tithing must be forgone to achieve confirmation of a debtor's repayment plan.[126] In many religious circles, tithing is considered a fundamental precept of religious faith and an invaluable source of financial support for religious institutions and purposes.[127] Thus, the Bankruptcy Code has obviously impaired an important religious freedom.

Once the initial showing is made, the focus then shifts to the second part of the *Sherbert* analysis which requires a demonstration of a compelling interest which would justify the burden on the religiously motivated conduct in question.[128] Concerning this second step, the *Green* court noted that it could not conceive of a compelling interest which would justify the obvious burden on the debtor's religion, nor had the state been able to offer one.[129] At this point, however, the reasoning of the *Green* court breaks down. In addressing the competing interests present in the case, the court limited its analysis to the religious concerns of the debtor and the effect the Bankruptcy Code would have on those concerns. By so doing, the bankruptcy court totally ignored the effect that confirmation of a chapter 13 plan which permitted tithing would have on unsecured creditors, who necessarily are directly affected by such a consequence.

In a 1969 article, J. Morris Clark commented that the right of individuals to take affirmative action which in some way harmed others in society "must by its nature be more restricted than the right to refrain from acting."[130] Clark noted that there were two competing interests present in a free exercise claim: the protection of established rights and interests from "positive infringement" on the one hand, and the freedom of individuals to live their lives according to the dictates

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[124] *See supra* notes 101-103 and accompanying text.

[125] *See supra* note 102 and accompanying text.

[126] *See supra* notes 60-88 and accompanying text.

[127] *See supra* notes 12-16 and accompanying text. *Cf. Sturgeon*, 51 Bankr. at 83 (bankruptcy court noted tithing should be encouraged because of financial support to church which allows church to give spiritual comfort and sustenance to community).

[128] *See supra* note 102 and accompanying text.

[129] *Green*, 73 Bankr. at 896. *See supra* note 47 (attempt to avoid establishment clause violation could be a compelling state interest but court viewed such a situation as not being present in the instant case).

[130] Clark, *Guidelines for the Free Exercise Clause*, 83 HARV. L. REV. 327, 361 (1969).

of their religious conscience on the other.[131] In an effort to strike a balance between these two interests, Clark proposed that "where an individual's conscience demands of him as an inexcusable duty the performance of a positive act *which can harm only himself and other fully consenting persons*, that act cannot be prohibited by the state. The state may, however, prohibit other positive actions, even ones impelled by conscience."[132] As a result, Clark went on to conclude that actions which harm nonconsenting third parties should not be exempted from state prohibitions, no matter how essential to one's religion an act is considered by the individual concerned.[133]

Whether confirmation of a chapter 13 plan similar to the one in *Green* will harm the unsecured creditors cannot seriously be questioned. The plan proposed by Mr. and Mrs. Green would repay the unsecured creditors 17 percent of their debts, as opposed to a 50 percent repayment if the monthly tithe to the debtors' church was not included.[134] The effect of confirmation of such a plan is to force the Greens' creditors to subsidize the debtors' free exercise of religion.[135] Surely, the scope of an individual's right to freely practice his religious beliefs does not include such a result. The freedom of debtors to practice their religious beliefs is not superior to the equally important right of the debtors' creditors to recoup their property interest as evidenced by the debt owed to them.[136] As a practical matter, the confirmation of a chapter 13 plan permitting a debtor to exempt a substantial portion of his disposable income from repayment to creditors represents a direct and serious injury to a nonconsenting third party.[137]

Although the direct harm to the creditors in *Green* has been identified, protection of these third parties must still be judged a compel-

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[131] *Id.*

[132] *Id.* (emphasis added).

[133] *Id.* at 362. Clark expressed the view that these guidelines provided a "coherent theory" for first amendment review. *Id.* at 365.

[134] *See supra* note 23.

[135] *Cf. Curry*, 77 Bankr. at 970 (bankruptcy court reasoned that it did not have discretion to permit debtor to require creditors to contribute to his chosen charity).

[136] *See* Pepper, *supra* note 89, at 371 (recognized freedom of one individual is not superior to equally valued freedom of another). *See also* Marcus, *supra* note 95, at 1230 ("[i]t has never been seriously suggested that rights under the free exercise clause are any more absolute than rights under any other section of the Constitution").

[137] *See* Pepper, *supra* note 89, at 370-71 (obvious limit to very broad interpretation of free exercise clause is that acts cannot be tolerated which involve significant harm to nonconsenting third parties); Note, *supra* note 4, at 373 (protection of legal rights of identifiable third parties not subject to the religious source of authority of individual would be protected even against cognizable religious claims).

ling state interest under the *Sherbert* analysis. Given the fact that rights under the free exercise clause carry no greater weight than the legally cognizable rights of innocent third parties,[138] the government's interest in protecting against substantial injury to unsecured creditors is undoubtedly compelling. In this regard, many legal commentators have expressed the view that protecting third parties from harm sustained by the religiously motivated conduct of another individual is an important and substantial state interest which can certainly be deemed compelling.[139] And although the issue seems never to have been directly addressed, some courts have impliedly recognized that protection of third parties is a compelling state interest.[140]

Finally, the *Sherbert* balancing test requires a showing that no less restrictive means exists of furthering the compelling state interest.[141] Since the filing of a chapter 13 plan is completely voluntary on the part of the debtor,[142] the only available means to protect the unsecured creditors is to deny the debtor confirmation of a plan which does not include all of the debtor's disposable income. Moreover, the only possible means of protecting the rights of third parties against unwarranted financial loss is to deny other individuals access to those avenues by which that loss would be caused.

The *Green* court's decision to allow a chapter 13 debtor a religious-based exemption causes substantial injury to nonconsenting creditors. Since protecting third parties from injury caused by affirmative acts of other individuals is a compelling state interest, any judicial determination which fails to evaluate the interests of third parties is

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[138] *See supra* note 136 and accompanying text.

[139] *See* Clark, *supra* note 130, at 361 (state may prohibit even those positive actions impelled by religious conscience); Pepper, *supra* note 89, at 371 (society may interfere through regulation or limitation when religiously motivated behavior interferes with equally important right of another); Note, *supra* note 4, at 373 (protection of third-party injury against even cognizable religious claims considered to be relevant state interest).

[140] *See* West Virginia State Bd. of Educ. v. Barnette, 319 U.S. 624, 630 (1943)(Court in dicta noted that state intervention was frequently required when freedom asserted by individuals conflict with rights asserted by other individuals); Robert Stigwood Group Ltd. v. O'Reilly, 348 F. Supp. 376, 383 (D. Conn. 1972), *aff'd*, No. 72-1826 (2d Cir. May 30, 1973)(unpublished order)(while court should be alert to protect free exercise of religious beliefs this does not include injury to another involving appropriation of literary, artistic and musical works). *See also* Note, *supra* note 4, at 368 n.101 (stating proposition that under present free exercise doctrine protection of third parties is recognized by courts as a compelling interest).

[141] *See supra* note 103 and accompanying text.

[142] *See* 11 U.S.C. § 1321 (1982)("[t]he debtor shall file a plan"). *See also* Butler & Morris, *supra* note 54, at 771 (consistent with voluntary nature of chapter 13 proceeding, only debtor may file repayment plan).

incomplete.

C. *Establishment Clause Analysis*

Although the focus of this Comment is on the free exercise clause, the establishment clause cannot totally be put aside. There are inherent conflicts between the two religion clauses, which has caused the Supreme Court to note that the provisions are "cast in absolute terms" and both, "if expanded to a logical extreme, would tend to clash with the other."[143] The strict scrutiny approach to free exercise claims begun by the Court in *Sherbert* has served to further magnify this inevitable tension.[144] In granting a religious-based exemption to a facially neutral statute, the decision by the bankruptcy court in *Green* evidences the strain visible between the establishment and free exercise clauses.

The three-prong test verbalized by the Court in *Lemon* is the current standard utilized in reviewing cases arising under the establishment clause.[145] The Supreme Court has applied the test in virtually all such cases since its formulation in 1971. [146] Notwithstanding the obvious longevity of the *Lemon* standard, several authors have subjected the test to intense criticism.[147] The most troublesome aspect of the *Lemon* test is the "secular purpose" prong, since if applied with literal force it would make *any* accommodation of religion a violation of the establishment clause.[148] It is this principle which makes suspect the

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[143] Waltz v. Tax Comm'n, 397 U.S. 664, 665-69 (1970).

[144] *See Developments*, *supra* note 2, at 1723 (inevitable tension exists between establishment clause and free exercise mandate as conceived since *Sherbert*).

[145] *See supra* note 27.

[146] *Cf.* Marsh v. Chambers, 463 U.S. 783, 786-795 (1983)(in concluding Nebraska legislature did not violate establishment clause by opening each session with prayer, the Court based its ruling on historical acceptance of practice).

[147] *See, e.g.*, Choper, *The Religion Clauses of the First Amendment: Reconciling the Conflict*, 41 U. PITT. L. REV. 673, 680 (1980)(application of three-prong test has generated ad hoc judgments which are incapable of being reconciled on any principled basis); Johnson, *Concepts and Compromise in First Amendment Religious Doctrine*, 72 CAL. L. REV. 817, 825-31 (1984)(criticism of all three prongs of *Lemon* test); Kurland, *The Irrelevance of the Constitution: The Religion Clauses of the First Amendment and the Supreme Court*, 24 VILL. L. REV. 3, 17-20 (1978)(criticism of all three parts of establishment clause test); Ripple, *The Entanglement Test of the Religion Clauses — A Ten Year Assessment*, 27 U.C.L.A. L. REV. 1195, 1216-24 (1980)(criticism of the entanglement portion of test).

[148] *See* Choper, *supra* note 147, at 685 ("secular purpose" prong of *Lemon* is most troublesome in that it would make virtually all accommodations for religion unconstitutional). *See also Developments*, *supra* note 2, at 1723 (three prongs of *Lemon*, if applied to free exercise claims, would foreclose all accommodation).

Green court's analysis of the *Lemon* secular purpose mandate.[149]

The secular purpose requirement of *Lemon* demands that the "principle or primary effect" of legislation or governmental action "must be one that neither advances nor inhibits religion."[150] If the intent of this standard is applicable to *any* governmental action, then the establishment clause is violated every time a court judicially accommodates a free exercise claim.[151] Thus, when a bankruptcy court creates an exception to the Bankruptcy Code for a chapter 13 debtor who wishes to tithe to his or her church, the primary effect of such an action is to advance the religion of such debtors — as clearly as if Congress had written the religiously based exception into the Bankruptcy Code itself. In his *Thomas* dissent, Justice Rehnquist recognized that judicially mandated accommodation of free exercise claims had the principal effect of advancing religion "by facilitating the exercise of religious belief."[152] Therefore, even though the *Green* court reached the conclusion that the benefit received by the debtor's church by allowing the debtor to tithe did not transgress the secular purpose prong of the *Lemon* test,[153] the court's action in creating an exception to the Bankruptcy Code for religiously motivated conduct in and of itself violates the establishment clause.

Some legal scholars have offered to justify this apparent inconsistency in the Supreme Court's establishment clause jurisprudence by reasoning that, when the two religion clauses clash, the establishment clause must be subordinated to the free exercise clause.[154] In view of this proposal, it is conceivable that the court in *Green*, after weighing the concerns of each clause, decided the free exercise concerns were paramount and chose to subordinate the establishment clause consid-

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[149] *See supra* notes 32-37 and accompanying text.

[150] *Lemon*, 403 U.S. at 612.

[151] *See Developments*, *supra* note 2, at 1723 (if *Lemon* is intended to apply to all governmental action, then Court violates constitutional command each time it upholds free exercise claim).

[152] *Thomas*, 450 U.S. at 726. Justice Rehnquist stated that if the state were to legislate the exception required by the *Thomas* majority, by passing a law granting unemployment benefits to persons quitting their jobs for religious reasons, the statute would violate all three prongs of the *Lemon* test. *Id.*

[153] *See supra* notes 33-37 and accompanying text.

[154] *See* Choper, *supra* note 147, at 690 (discussing view that free exercise clause should have priority over establishment clause because establishment clause is largely designed to implement free exercise clause); Moore, *The Supreme Court and the Relationship Between the "Establishment" and "Free Exercise" Clauses*, 42 TEX. L. REV. 142, 196 (1963)(free exercise clause will and should prevail over establishment clause since latter was largely designed to implement former).

erations. Protection of the free exercise rights of individuals is an admirable goal, and a very broad interpretation of the free exercise clause which grants religiously motivated conduct, such as tithing, priority over establishment clause values may be a worthwhile objective. Assuming this to be true, however, such free exercise claims should not be held in higher esteem than equally important rights of third parties. The inherent conflicts between the religion clauses and the weighing of the interests represented by each clause have little importance where an individual's free exercise conduct directly harms a nonconsenting third party. In such an instance, the third party should be protected from such harm no matter how highly regarded the interests underlying the free exercise claim.[155]

V. Conclusion

Many debtors may be faced with the dilemma of complying with the requirements of the Bankruptcy Code in violation of their religious faith or risking non-confirmation of their chapter 13 plan by refusing to comply with those provisions which conflict with their beliefs. For the most part, bankruptcy courts construing chapter 13 have been unwilling to allow debtors to tithe under a repayment plan, either because the tithe is considered to be part of the debtor's disposable income, or because such a plan is not deemed to have been filed in good faith.

In *In re Green*, the United States Bankruptcy Court for the Western District of Michigan granted a chapter 13 debtor a free exercise right to impose a monthly tithe to the debtor's church upon the debtor's unsecured creditors. In reaching this result, the *Green* court did not consider the effect of confirmation of such a plan on the creditors. The plan proposed by the debtors in *Green* would impose a substantial financial harm to their unsecured creditors. Although the court applied the appropriate standard for a free exercise case, it did not evaluate the case in light of the compelling interest the government has in protecting third parties from injurious acts. Since a compelling state interest exists in *Green* which justifies the burden imposed on the debtors' religion, and there is no less restrictive means of furthering that state interest, the debtors' chapter 13 repayment plan was incorrectly confirmed by the bankruptcy court.

David W. Case

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[155] *See supra* note 133 and accompanying text.

THE NEW CHAPTER 12 OF THE BANKRUPTCY CODE: A MORE EFFICIENT APPROACH FOR FAMILY FARMER REORGANIZATION

I. Overview of Farmer Relief Under Chapters 7, 11, and 13

Prior to the enactment of chapter 12 of the Bankruptcy Code — Adjustment of Debts of a Family Farmer With Regular Income,[1] family farmers could file for relief under chapters 7, 11, and 13 of the Code, but for various reasons, these chapters have proven inadequate.

Chapter 7 is the liquidation chapter in which the farmer could obtain a fresh start but not save the farm.[2] Unless the family farmer could work out an agreement with the lienholder or purchase the farm at a trustee's sale, the utilization of chapter 7 would result in the loss of the farm.

The farmer could attempt reorganization under chapter 13[3] but most farmers are ineligible because of the low debt ceilings of $100,000 for unsecured claims[4] and $350,000 for secured claims.[5] In addition, incorporated farms are ineligible since this chapter is designed specifically for individuals.[6] Other disadvantages include the requirement that the plan be filed within 15 days of the petition,[7] and the requirement that payments start within 30 days of confirmation of the plan.[8]

In an effort to avoid the complications presented by chapters 7 and 13, many family farmers have sought relief under chapter 11.[9] Unfortunately, this chapter has proven to be unduly time-consuming, too expensive and simply inadequate in many farmer reorganization

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[1] 11 U.S.C. §§ 1201-1231 (Supp. IV 1986).

[2] 11 U.S.C. §§ 701-766 (1982 & Supp. IV 1986).

[3] 11 U.S.C. §§ 1301-1330 (1982 & Supp. IV 1986).

[4] 11 U.S.C. § 109(e) (1982).

[5] *Id.*

[6] Chapter 13 of the Bankruptcy Code is entitled Adjustment of Debts of an Individual with Regular Income. An "individual with regular income" is defined as someone whose income is sufficiently stable and regular to enable that person to make payments under a chapter 13 plan. 11 U.S.C. § 101(29)(Supp. IV 1986). Although chapter 13 is designed for individuals, the definition is broad enough to include proprietors of small businesses and farms. Lee, *Chapter 13 nee Chapter XIII*, 53 Am. Bankr. L.J. 303, 304 (1979). The debt ceilings, which preclude most farms from obtaining relief under chapter 13, are designed to exclude large businesses. *Id.*

[7] Bankr. R. 3015.

[8] 11 U.S.C. § 1326(a)(1) (Supp. IV 1986).

[9] 11 U.S.C. §§ 1101-1174 (1982 & Supp. IV 1986).

cases.[10] Creditors are entitled to vote down reorganization plans and often do even though these creditors would receive more through a plan than in a foreclosure.[11] Other obstacles to family farmer reorganization under chapter 11 are the absolute priority rule,[12] the election of secured creditors,[13] and the need to provide adequate protection for lost opportunity costs.[14] Moreover, where a farmer is unsuccessful in having a plan confirmed, a creditor is authorized to file a plan requesting the liquidation of the debtor's property.[15] The creditor's plan envisioned in chapter 11 is in effect an involuntary liquidation of the farming property and serves as a substantial deterrence to utilization of the chapter.

II. Reorganization of the Family Farmer Under Chapter 12

The new chapter 12 of the Bankruptcy Code, an emergency chapter specifically tailored to the realities of a nationwide farm crisis, was exclusively enacted for family farmers facing bankruptcy. Cognizant of the needs of both family farmers and agricultural creditors, Congress intended the chapter's provisions to fairly meet the financial objectives of both.[16] The purpose of chapter 12 is to prevent a forced liquidation of the farm by giving the farmer a fighting chance to save and maintain the farming operations while paying off the debt from its earnings.[17] Although chapter 12 is primarily modeled after chapter 13, it also contains provisions from chapter 11 as well as original provisions specifi-

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[10] J. Anderson, *An Analysis of Pending Bills to Provide Family Farmer Debtor Relief Under the Bankruptcy Code*, 132 Cong. Rec. S15076-91 (daily ed. Oct. 3, 1986).

[11] 11 U.S.C. § 1129(a)(8) (1982).

[12] 11 U.S.C. § 1129(b)(2)(B)(ii) (1982 & Supp. IV 1986). *See* In re Ahlers, 794 F.2d 388, 401 (8th Cir. 1986)(section 1129(b)(2)(B) applies modified version of traditional absolute priority rule which states that dissenting class of unsecured creditors must be provided for in full before any junior class can receive or retain property under plan).

[13] 11 U.S.C. § 1111(b) (1982). *See generally* Klee, *All You Ever Wanted to Know About Cram Down Under the New Bankruptcy Code*, 53 Am. Bankr. L.J. 133, 152-156 (1979)(general discussion of right of secured creditors to elect application of special treatment under section 1111(b)(2)).

[14] 11 U.S.C. § 361 (1982 & Supp. IV 1986). *See Ahlers*, 794 F.2d at 395 (secured creditor entitled to adequate protection of security interest); In re Martin, 761 F.2d 472, 476 (8th Cir. 1986)(review of legislative history indicates that in structuring proposal of adequate protection of secured creditor debtor should provide creditor with value of his bargained for rights as nearly as possible under circumstances).

[15] 11 U.S.C. § 1121(c)(3) (1982 & Supp. IV 1986).

[16] *See* 132 Cong. Rec. S15074, 15092 (daily ed. Oct. 3, 1986)(statement of Sen. Hatch).

[17] H.R. Rep. No. 958, 99th Cong., 2d Sess. 48 (1986).

cally designed to meet the unique financial structure of the farmer.[18]

Chapter 12 is intended to aid in the preservation of the family farm while at the same time serving to maintain the integrity of the bankruptcy system and to protect bona fide farm creditors.[19] However, the new chapter is not intended to become a permanent fixture in the Bankruptcy Code. Because the legislation was enacted in emergency response to the farm crisis, Congress imposed a seven year sunset provision which provides for repeal of chapter 12 on October 1, 1993.[20]

A. Chapter 12 Eligibility Requirements

The intent of Congress is that chapter 12 relief should be available only to *true family farmers*, their partnerships and corporations with regular annual income, and unavailable to operations functioning as tax shelters or "recreational" farms.[21] Therefore, Congress imposed strict eligibility requirements. Section 101(18) defines a family farmer with regular income to mean a "family farmer whose annual income is sufficiently stable and regular to enable such family farmer to make payments under a plan under chapter 12 of this title."[22] First, a family farmer's aggregate debts cannot exceed $1,500,000 (exclusive of any debt for his principal residence, unless the residence debt arises out of the farming operation).[23] Second, if the farmer is an individual, not less than 80 percent of his debts and more than 50 percent of the farmer's gross income from the preceding taxable year must be derived from the farming operations.[24] If the operation of a family farmer is conducted through a corporation or partnership, it may qualify for chapter 12 relief if more than 50 percent of the outstanding stock or equity is held by one family or relatives of the family who conduct the farm business.[25] Further, more than 80 percent of the value of the cor-

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[18] *See* J. ANDERSON & J. MORRIS, CHAPTER 12 FARM REORGANIZATIONS, § 1.22 (1987)(overview of chapter 12 reorganizations for family farmers).

[19] *See* 132 CONG. REC. S15074, 15092 (daily ed. Oct. 3, 1986)(statement of Sen. Hatch).

[20] Chapter 12 contains a note immediately preceding 11 U.S.C. § 1201 indicating the date upon which the chapter will be repealed. *See* H.R. REP. No. 958, 99th Cong., 2d Sess. 48 (1986)(explanation of purpose behind including sunset provision in chapter 12).

[21] *See* 11 U.S.C. § 109(f) (Supp. IV 1986)(defining family farmer debtor for purposes of chapter 12).

[22] 11 U.S.C. § 101(18) (Supp. IV 1986). *Cf.* 11 U.S.C. § 101(29) (Supp. IV 1986)(identical language used to determine an individual with regular income for purposes of chapter 13).

[23] 11 U.S.C. § 101(17)(A) (Supp. IV 1986).

[24] *Id.*

[25] 11 U.S.C. § 101(17)(B) (Supp. IV 1986).

porate assets must consist of assets related to the farming operation.[26] The aggregate corporate debts cannot exceed $1,500,000 (exclusive of the debt for one principle residence owned by the corporation or partnership) and 80 percent of its aggregate non contingent, liquidated debts must arise out of the farm operation.[27] Lastly, if the corporation issues stock, the stock cannot be publicly traded.[28]

B. Similarities and Dissimilarities of Chapter 12 to Chapters 11 and 13

Under chapter 12, farmers are given many of the rights and benefits of debtors utilizing chapters 11 and 13.[29] Chapter 12 alters those provisions inappropriate for family farmers undergoing reorganizations.[30]

1. Filing the Chapter 12 Petition

Involuntary petitions may not be initiated against a farmer to commence a chapter 12 reorganization case.[31] As in chapters 7, 11, and 13, the filing of a voluntary chapter 12 petition[32] operates as an automatic stay of actions against the farmer and his property.[33] This stay also prohibits any collection of consumer debts against a codebtor of the farmer.[34] Because the codebtor stay does not include agricultural debts, this provision is unlikely to be of significant benefit.

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[26] 11 U.S.C. § 101(17)(B)(i) (Supp. IV 1986).

[27] 11 U.S.C. § 101(17)(B)(ii) (Supp. IV 1986).

[28] 11 U.S.C. § 101(17)(B)(iii) (Supp. IV 1986).

[29] Chapters 1, 3 and 5 of the Bankruptcy Code are all made applicable to chapter 12 reorganizations.

[30] *See* H.R. REP. No. 958, 99th Cong., 2d Sess. 48 (1986)(conferees overview of chapter 12 provisions).

[31] *See* 11 U.S.C. § 303(a) (1982 & Supp. IV 1986). The section states that an involuntary petition may be filed only under chapter 7 or 11 of the Bankruptcy Code, and even then an involuntary petition may not be filed against a family farmer. *Id.*

[32] *See* 11 U.S.C. § 301 (1982)(voluntary case under any chapter of Bankruptcy Code is commenced by filing petition by entity that may be debtor under such chapter).

[33] 11 U.S.C. § 362 (1982 & Supp. IV 1986). The secured creditor must file a motion to have the stay lifted in order to proceed with foreclosure. The primary basis for lifting the stay is lack of adequate protection. *See infra* note 55 (discussing exclusion of adequate protection for lost opportunity costs in chapter 12 cases). *See also* J. ANDERSON & J. MORRIS, *supra* note 18, at §§ 5.05, 5.06 (detailed analysis of automatic stay and adequate protection application in chapter 12 cases).

[34] 11 U.S.C. § 1201(a) (Supp. IV 1986).

2. Treatment of Assets and Collateral Under Chapter 12

Although a trustee is appointed in every chapter 12 reorganization, the farmer is generally allowed to remain in possession of the assets of the estate and to continue the operation of the farming business as a "debtor in possession" unless he is removed by the court.[35] This vests in the debtor virtually all of the same rights, powers and duties as a chapter 11 trustee or debtor in possession.[36] Generally, this status gives the farmer the exclusive right to file the plan of reorganization[37] and the broad powers to continue the farming business and maintain any legal actions adverse to the estate.[38] Specifically, the chapter 12 debtor in possession may use, sell or lease the assets,[39] obtain credit,[40] and deal with executory contracts[41] and unexpired leases[42] in the ordinary course of business without first notifying creditors or obtaining court approval.[43]

The congressional conferees noted that a successful reorganization would commonly involve the sale of unnecessary property.[44] Family farmers are specifically allowed in section 1206 to sell assets not needed for the reorganization prior to confirmation without the consent of the secured creditors.[45] In addition, section 1206 specifically authorizes the sale of assets free and clear of liens after notice and a hearing.[46] The lien attaches to the proceeds at the time of sale.[47] However, the use of cash collateral[48] by the debtor is strictly prohibited

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[35] *See* J. ANDERSON & J. MORRIS, *supra* note 18, at §§ 4.01-4.05 (describing rights, powers and duties of debtor in possession).

[36] 11 U.S.C. § 1203 (Supp. IV 1986). This section is virtually a word for word adoption of section 1107(a) which defines the rights, powers and duties of a chapter 11 debtor in possession. Therefore, one can assume that the chapter 12 debtor in possession will have the same rights and powers as a chapter 11 debtor in possession. As a result, it will be necessary to look to chapter 11 guidelines and caselaw to interpret the role of the chapter 12 debtor.

[37] 11 U.S.C. § 1221 (Supp. IV 1986).

[38] *See generally* 5 COLLIER ON BANKRUPTCY § 1107.01 *et. seq.* (15th ed. 1984); BANKR. R. 6009.

[39] 11 U.S.C. § 363 (1982 & Supp. IV 1986); 11 U.S.C. § 1206 (Supp. IV 1986).

[40] 11 U.S.C. § 364 (1982 & Supp. IV 1986).

[41] 11 U.S.C. § 365 (1982 & Supp. IV 1986).

[42] *Id.*

[43] *See* J. ANDERSON & J. MORRIS, *supra* note 18, at §§ 4.03-4.04 (discussing rights and powers of debtor in possession in the ordinary course of business).

[44] H.R. REP. No. 958, 99th Cong., 2d Sess. 50 (1986).

[45] *Id.*; 11 U.S.C. § 1206 (Supp. IV 1986).

[46] 11 U.S.C. § 1206 (Supp. IV 1986).

[47] H.R. REP. No. 958, 99th Cong., 2d Sess. 50 (1986).

[48] Cash collateral consists of cash, negotiable instruments, documents of title, secur-

unless the secured creditor consents,[49] or the court, after notice and hearing, authorizes such use.[50] The use of cash collateral is crucial to a successful reorganization in many chapter 12 cases since the farmer will often need to use the cash collateral immediately after filing in order to pay expenses so that farming operations can be continued.[51]

The ability to utilize and sell property under chapter 12 may be modified or terminated when parties to the proceeding move the court under Bankruptcy Rule 4001 to restrict the utilization of property in which the objecting party has an interest, until and unless adequate protection can be furnished to the objector.[52] The case law involving farmers under chapter 11 concerning adequate protection for the claims of secured creditors may be analogous and applied to some degree in chapter 12 cases.[53] Generally, in both chapters 11 and 12, a

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ities, deposit accounts and other cash equivalents in the debtor's estate in which a creditor retains a security interest. 11 U.S.C. § 363(a) (1982 & Supp. IV 1986).

[49] 11 U.S.C. § 363(c)(2)(A) (1982).

[50] 11 U.S.C. § 363(c)(2)(B) (1982). *See also* H.R. REP. No. 958, 99th Cong., 2d Sess. 49 (1986)(recommending application of existing legal precedents when considering applications to use cash collateral).

[51] Bankruptcy Rule 4001 was recently amended to remedy this problem. The debtor must file a motion for authorization of the use of the collateral in accordance with Bankruptcy Rule 9014 and give proper notice to the secured creditor and other parties. The bankruptcy court may then commence a final hearing on the motion not earlier than five days after service of the motion. In the alternative, the court may conduct a preliminary hearing before the five-day period expires if the motion so requests and irreparable injury to the estate is shown. Within its discretion, the court may then authorize the debtor to use that amount of collateral as is necessary to avoid immediate and irreparable harm to the estate pending a final hearing. Moreover, if irreparable injury will occur to a farmer's crops or investor, the court may allow the use of the collateral on an ex parte basis immediately upon filing. *See* J. ANDERSON & J. MORRIS, *supra* note 18, at § 5.044 (analysis of procedural guidelines for use of cash collateral).

[52] BANKR. R. 4001.

[53] Some chapter 11 cases have held that where the farm land or farm equipment is necessary for the reorganization effort of the farmer and where adequate protection, if needed, could be provided to complaining secured creditors, no relief from the stay would be granted, regardless of whether there is equity in the collateral. *See e.g.*, In re Ahlers, 794 F.2d 388, 394 (8th Cir. 1986)(sufficient protection provided, thus stay remained in force); In re Martin, 761 F.2d 472, 478 (8th Cir. 1985)(stay to remain in force where adequate protection provided by farmer); In re Berens, 41 Bankr. 524, 526 (Bankr. N.D. Minn. 1984)(debtors provided adequate protection by way of replacement lien on subsequent year's crop); In re Selby Farms, Inc., 15 Bankr. 372, 374 (Bankr. S.D. Miss. 1981)(for stay to remain in effect court need only determine that creditor is adequately protected).

Other chapter 11 cases have held against the farmer by lifting the stay to allow secured creditors to foreclose on farm property. *See, e.g.*, In re Moor, 51 Bankr. 640, 643-44 (Bankr. N.D. Miss. 1985)(automatic stay should be lifted since debtor had no equity

creditor must show that a debtor lacks equity in the collateral in question, the collateral is not necessary for an effective reorganization, and the debtor cannot furnish adequate protection to the secured creditor in order to protect against any reduction in the value of the collateral that is caused by (or occurs contemporaneously with) the use of the collateral in conjunction with the delay imposed by the automatic stay.[54] However, in chapter 11 cases, there is continual dispute over the need to compensate a creditor not only for loss of collateral value due to the use of it by the debtor in possession, but also for *lost opportunity costs*.[55]

A significant problem in chapter 11 bankruptcy is that the farmer cannot provide adequate protection for lost opportunity costs.[56] The payment of lost opportunity costs requires the periodic payment of a sum of cash equal to the interest that the undercollateralized secured creditor might earn on an amount of money equal to the value of the collateral securing the debt.[57] Farmland values have dropped dramati-

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in property and reorganization in farming business did not appear likely); In re Engle, 51 Bankr. 190, 192 (Bankr. E.D. Pa. 1985)(creditor entitled to relief from stay where there was no reasonable probability that debtor could rehabilitate dairy farming business within reasonable time); In re Polzin, 49 Bankr. 370, 374 (Bankr. D. Minn. 1985)(adequate protection offer of debtor held insufficient); In re Hagendorfer, 42 Bankr. 13, 15 (Bankr. S.D. Ala. 1984)(creditors may proceed immediately against property where debtor has no equity and property is unnecessary to reorganization, even where debtor can provide adequate protection); In re Hinton, 30 Bankr. 796, 798-99 (Bankr. M.D. Tenn. 1983)(creditor entitled to relief from automatic stay where debtors had no equity and value of farm had significantly declined and could continue to decline).

[54] 11 U.S.C. § 362(d)(2) (1982 & Supp. IV 1986).

[55] Lost opportunity costs are those amounts which a secured creditor would earn if it were allowed to foreclose on its lien, sell the collateral and reinvest proceeds. These costs may be roughly measured by the reinvestment income that could have been earned by the secured creditor had the automatic stay not prevented foreclosure, liquidation and reinvestment. Some courts have deemed these costs to be the equivalent of post petition interest payments. The conflicting views on this subject in context of chapter 11 cases can be found in three primary cases. *See* In re Timbers of Inwood, 793 F.2d 1380, 1381 (5th Cir. 1986)(undersecured creditors are not entitled to lost opportunity costs or postpetition interest payments and are only entitled to adequate protection for diminution and value of their collateral, if any, during chapter 11 proceeding); In re Briggs Transp. Co., 780 F.2d 1339, 1351 (8th Cir. 1986)(undersecured creditors may be entitled to postpetition interest payments and/or opportunity costs depending on facts of case, including nature of collateral and proposed use of it, however, undersecured creditors are not entitled to such as matter of law); In re Am. Mariner Indus., Inc., 734 F.2d 426, 435 (9th Cir. 1984)(undersecured creditors are entitled to lost opportunity costs).

[56] *See* H.R. REP. No. 958, 99th Cong., 2d Sess. 49 (1986)(discussion of providing adequate protection for such costs).

[57] *Id.*

cally in many areas of the country which has caused numerous loans to be undercollateralized. Thus, lost opportunity costs create serious barriers to farm reorganizations since many farmers are unable to make these payments.[58] In response, chapter 12 completely eliminates the need to provide adequate protection for lost opportunity costs.[59] Instead, separate tests for adequate protection in chapter 12 are provided.[60] Under section 1205(b)(3), adequate protection may be provided for the use of the farmland by paying to the lienholder the reasonable rent customary in the community where the property is located based upon the rental value, net income and earning capacity of the property.[61] Presumably, this provision will reduce unnecessary litigation during the term of the automatic stay, and will allow the family farmer to devote proper attention to plan preparation.[62]

The debtor in possession is also allowed to convert pending chapter 7,[63] 11[64] and 13[65] cases to chapter 12, but only where the court finds such a conversion equitable between the rights of both the debtors and creditors.[66] Chief among the factors in allowing conversion is whether

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[58] *Id.*

[59] *See* 11 U.S.C. § 1205(a) (Supp. IV 1986)(section 361 does not apply to case under chapter 12).

[60] *See* 11 U.S.C. § 1205(b) (Supp. IV 1986). Under section 1205(b), adequate protection (i.e., maintenance of collateral value) may be furnished by the following methods:

> (1) An equity cushion in the collateral (e.g., excess value or equity as compared to the amount of the secured claim to satisfy the payment of such claim);
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> (2) periodic payments equal to the dimunition of collateral value so as to preserve the secured creditor's position;
>
> (3) an additional or replacement lien on property having a value in excess of any collateral dimunition (especially where there is no equity cushion in the existing collateral);
>
> (4) reasonable rent payments for farmland customary in the community where the property is located based upon the rental value, net income, and earning capacity of the farmland; or
>
> (5) granting any other form of relief (other than granting an administrative claim) to preserve or replace the lost or diminished value in the collateral.

11 U.S.C. § 1205(b)(1-4) (Supp. IV 1986).

[61] 11 U.S.C. § 1205(b)(3) (Supp. IV 1986).

[62] *See* H.R. REP. No. 958, 99th Cong., 2d Sess. 50 (1986).

[63] 11 U.S.C. § 706(a) (Supp. IV 1986).

[64] 11 U.S.C. § 1112(d) (Supp. IV 1986).

[65] 11 U.S.C. § 1307(e) (Supp. IV 1986).

[66] *See* 11 U.S.C. § 1112(d)(3) (Supp. IV 1986)(if debtor requests conversion from chapter 11 to chapter 12, such conversion will be made only if equitable). *See also* H.R. REP. No. 958, 99th Cong., 2d Sess. 48 (1986). Actions taken in pending cases will be considered in the court's decision of whether conversion is proper. If the petition in another chapter was recently filed with no further action taken, then conversion to chapter

there is substantial likelihood of successful reorganization under chapter 12.[67] Additionally, the debtor in possession has the right to dismiss a chapter 12 case[68] and to convert the case to chapter 7.[69] A chapter 12 debtor may be removed as a debtor in possession "on request of a party in interest" after notice to all parties and a hearing if the court finds the farmer guilty of fraud, dishonesty, incompetence, or gross mismanagement of the estate.[70]

3. The Chapter 12 Trustee

To serve as a watchdog for the rights of creditors, a trustee who has the identical rights of a chapter 13 trustee is *automatically* appointed in every chapter 12 case.[71] The duties required are essentially the same as those of a chapter 13 trustee.[72] Furthermore, the chapter 12 trustee is given the additional duty to appear and be heard with respect to sales of property of the estate.[73] The right to review sales is particularly important in farm cases where sales are frequently made to family members and neighbors.

If the farmer is removed as a "debtor in possession," the trustee will have the additional duties of taking possession of the debtor's assets, performing the duties of the debtor, and maintaining the farming operations.[74] Notwithstanding the loss of the farmer's rights as a debtor in possession, the debtor will retain the exclusive right to file a plan of reorganization and will continue to be a party in interest who may object to any proposed actions of the chapter 12 trustee, creditors

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12 may be warranted. *Id.* On the other hand, if the reorganization plan was previously filed and confirmed or other steps were substantially complied with, then the availability of conversion to chapter 12 will be limited. *Id.*

[67] H.R. REP. No. 958, 99th Cong., 2d Sess. 48 (1986).

[68] 11 U.S.C. § 1208(b) (Supp. IV 1986). A party in interest may have a case dismissed for cause. 11 U.S.C. § 1208(c) (Supp. IV 1986).

[69] 11 U.S.C. § 1208(a) (Supp. IV 1986). A case may be involuntarily converted to a case under chapter 7 if the debtor committed fraud in connection with the case. 11 U.S.C. § 1208(d) (Supp. IV 1986).

[70] 11 U.S.C. § 1204(a) (Supp. IV 1986). The court has the power to reinstate the debtor in appropriate cases. 11 U.S.C. § 1204(b) (Supp. IV 1986).

[71] 11 U.S.C. § 1202(a) (Supp. IV 1986). The United States trustee will make this appointment. *Id.*

[72] *Compare* 11 U.S.C. § 1202(b) (Supp. IV 1986) *with* 11 U.S.C. § 1302(b) (1982 & Supp. IV 1986).

[73] 11 U.S.C. § 1202(b)(3)(D) (Supp. IV 1986).

[74] 11 U.S.C. § 1202(b)(5) (Supp. IV 1986). In appropriate cases, the trustee may move for a dismissal or for conversion to chapter 7. 11 U.S.C. § 1208(c) and (d) (Supp. IV 1986).

or other parties.[75]

4. Contents of the Chapter 12 Plan

Unlike chapter 11, creditors are not permitted to file a plan to involuntarily liquidate the farmer's assets.[76] The chapter 12 debtor has the exclusive right to file the plan of reorganization.[77] In addition, creditors have no right to vote on the plan,[78] and the plan need not comply with the rule of absolute priority in order to be confirmed.[79]

The chapter 12 plan must be filed not later than 90 days after the order for relief except that the court may extend the 90 day period "if an extension is substantially justified."[80] The failure to file a plan timely is grounds for dismissal of the case.[81] The 90 day filing period is a significantly longer period than that allowed in a chapter 13 case,[82] but is significantly less than the period allowed under chapter 11.[83] The plan confirmation hearing must normally be held within 45 days after the plan is filed.[84] The requirements for the contents and confirmation of the chapter 12 plan are essentially identical to those in section 1332 of chapter 13.[85]

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[75] *See* H.R. REP. No. 958, 99th Cong., 2d Sess. 48 (1986)(explaining duties of trustees after dispossession of debtor-in-possession).

[76] *See* 11 U.S.C. § 1121(c) (1982 & Supp. IV 1986)(any party in interest may file plan). There is no comparable provision to section 1121(c) in chapter 12 of the Bankruptcy Code.

[77] 11 U.S.C. § 1221 (Supp. IV 1986).

[78] Although creditors do not have the right to reject the plan under chapter 12, they may object to confirmation of the plan at a confirmation hearing. 11 U.S.C. § 1224 (Supp. IV 1986).

[79] *See* 11 U.S.C. § 1222(b) (Supp. IV 1986)(chapter 12 plan *may* designate a class or classes of claims but not required). *Contra* 11 U.S.C. § 1123(a) (1982 & Supp. IV 1986)(chapter 11 plan *shall* designate classes of claims). The absolute priority rule provides that each senior class in a reorganization must be satisfied in full before the next descending or junior class receives anything. In re Ahlers, 794 F.2d 388, 401 (8th Cir. 1986). *See also* Klee, *supra* note 13, at 143-71 (expanded discussion of how rule of absolute priority has been modified under present Bankruptcy Code).

[80] 11 U.S.C. § 1221 (Supp. IV 1986).

[81] 11 U.S.C. § 1208(c)(3) (Supp. IV 1986).

[82] A chapter 13 plan may be filed with the petition. If it is not, the plan must be filed within 15 days. BANKR. R. 3015. The time period for filing may be extended by the court for cause. *Id.*

[83] Under chapter 11, the debtor has the exclusive right to file a plan for 120 days. 11 U.S.C. § 1121(b) (1982). Other parties may file a plan if a trustee is appointed, no plan is filed by the debtor within the exclusive period, or if a plan is not confirmed with 180 days of the order for relief. 11 U.S.C. § 1121(c) (1982 & Supp. IV 1986).

[84] 11 U.S.C. § 1224 (Supp. IV 1986).

[85] *Compare* 11 U.S.C. § 1222 (Supp. IV 1986) *with* 11 U.S.C. § 1322 (1982 & Supp.

A significant difference of chapter 12 from chapter 13 is the allowance for the classification of claims and interests in the debtor's plan.[86] Under chapter 13 there is no need to classify claims and interests since the chapter is tailored primarily to the needs of individuals. However, in a chapter 12 case, the debtor may be a corporation and thus a need for classification exists.

Generally, the discrimination against any class of unsecured claims is prohibited under chapter 12.[87] An exception does exist for consumer debts on which an individual is also liable.[88] The opportunity to provide a different treatment for consumer debts should not be of significant importance since 80 percent of the farmer's debts must be agricultural debts which do not fall within the definition of consumer debt.[89]

A chapter 12 plan must provide for the full payment of priority claims under section 507 (including priority taxes).[90] Unlike chapter 11, interest is not required for priority claims.[91] Furthermore, the time periods for payment are considerably shorter under chapter 12. A chapter 12 plan must normally provide for payment within three years with an exception for cause, if the court grants approval, for a maximum of five years.[92] In comparison, priority tax claims under chapter 11 may extend over a six year period.[93] The shorter time periods under chapter 12 facilitate the chapter's goal of expeditiously and efficiently reorganizing the farmer debtor.

Modification of the rights of the holders of both secured and unsecured claims may also be provided for under a farmer debtor's chapter 12 plan.[94] This is especially important because it permits the scaling down of the secured debt to the value of the underlying collateral. The chapter 12 provision does not contain the limitation with respect

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IV 1986).

[86] 11 U.S.C. § 1222(a)(3) (Supp. IV 1986).

[87] 11 U.S.C. § 1222(b)(1) (Supp. IV 1986).

[88] *Id.*

[89] *See generally* J. ANDERSON & J. MORRIS, *supra* note 18, at §§ 9.08-9.14 (overview of classification of claims in chapter 12 plans).

[90] 11 U.S.C. § 1222(a)(2) (Supp. IV 1986).

[91] *See* 11 U.S.C. § 1123(a)(1) (1982 & Supp. IV 1986)(chapter 11 plan shall designate classes of claims other than those entitled to priority under section 507 and classes of interests).

[92] 11 U.S.C. § 1222(c) (Supp. IV 1986). The time limitation does not apply to the payment of secured claims or to long term claims where the default is cured within a reasonable time and regular payments are resumed. 11 U.S.C. § 1222(b)(5) (Supp. IV 1986); 11 U.S.C. § 1222(b)(9) (Supp. IV 1986).

[93] 11 U.S.C. § 1129(9)(C) (1982 & Supp. IV 1986).

[94] 11 U.S.C. § 1222 (b)(2) (Supp. IV 1986).

to liens on the debtor's residence found in section 1322(b)(2) of chapter 13.[95]

The plan may also provide for the curing or waiving of any default within a reasonable period of time.[96] As in section 1322(b)(5) of chapter 13,[97] the chapter 12 debtor may de-accelerate a debt by maintaining the regular payments and curing the arrearage over a reasonable period of time.[98] These de-acceleration provisions are more favorable to the debtor than those provisions in chapter 11 which require the immediate cure of the default and compensation to the holder of the claim for any damage resulting from reliance on the contract which was the subject of the default.[99] A provision allowing the assumption, rejection or assignment of any executory contract or unexpired lease may also be included in the contents of a chapter 12 plan.[100]

Finally, a chapter 12 plan may permit the debtor to sell "all or any part" of the property of the estate[101] and provide for the payment of all or a part of a claim against the debtor from this property.[102] This is a modification of section 1123(b)(4) of chapter 11[103] which reflects recognition of the fact that many family farm cases involve the sale of

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[95] *Compare* 11 U.S.C. § 1322(b)(2) (1982 & Supp. IV 1986)(claim secured only by security interest in debtor's principal residence may not be modified) *with* 11 U.S.C. § 1222(b)(2) (Supp. IV 1986)(no similar language concerning debtor's principal place of residence).

[96] *See* 11 U.S.C. § 1222(b)(3) (Supp. IV 1986)(plan may provide for curing or waiving any default); 11 U.S.C. § 1222(b)(5) (Supp. IV 1986)(plan may provide for curing of any default within reasonable time).

[97] 11 U.S.C. § 1322(b)(5) (1982).

[98] 11 U.S.C. § 1222(b)(5) (Supp. IV 1986). Chapter 13 cases holding that the balance of a defaulted mortgage which was "accelerated" before the petition may be "de-accelerated" under section 1322(b)(5) are applicable to section 1222(b)(5). *See, e.g.*, Matter of Clark, 738 F.2d 869, 874 (7th Cir. 1984)(power to cure default provided by section 1322(b)(5) permits debtor to de-accelerate payments even though acceleration occurred prior to filing of chapter 13 petition); Grubbs v. Houston First Am. Sav. Ass'n, 730 F.2d 236, 242 (5th Cir. 1984)(permitting debtors to de-accelerate by payment of arrearages will encourage good faith negotiations and discourage race to courthouse to file chapter 13 petition prior to acceleration). *See also* Sable, *A Chapter 13 Debtor's Right to Cure Default Under Section 1322(b): A Problem of Interpretation*, 57 AM. BANKR. L.J. 127, 139-40 (1983)(favorable commentary on policy of de-acceleration). *But see* In re Seidel, 752 F.2d 1382, 1383 (9th Cir. 1985)(section 1322(b) cannot be used to de-accelerate a debt which had already fully matured and was immediately due and payable before plan filed).

[99] 11 U.S.C. § 1124(2) (1982 & Supp. IV 1986).

[100] 11 U.S.C. § 1222(b)(6) (Supp. IV 1986).

[101] 11 U.S.C. § 1222(b)(8) (Supp. IV 1986).

[102] 11 U.S.C. § 1222(b)(7) (Supp. IV 1986).

[103] 11 U.S.C. § 1123(b)(4) (1982).

assets to reduce debt.

5. Confirmation of the Chapter 12 Plan

Chapter 12 contains no provision which states when payments must commence. However, the new chapter does specifically require the trustee to ensure that the debtor commences making timely payments as required by a confirmed plan.[104] Moreover, the failure to commence making such payments is cause for dismissal of a chapter 12 plan.[105] In contrast, chapter 13 requires that payments commence within thirty days after the plan is filed, unless the court orders otherwise.[106]

Confirmation of a chapter 12 plan takes place at a hearing conducted 45 days after the plan is filed.[107] Aware of the time constraints this would impose on the bankruptcy courts, the congressional conferees provided an exception for cause to extend the time period.[108] The conferees suggest in their statement that the exception for cause should be granted "sparingly," but that a backlog of cases was sufficient cause for an extension of the 45 day period.[109]

Creditors, the trustee or any party in interest may object to confirmation of the plan.[110] However, creditors are not permitted to vote on the plan and the plan can be confirmed in the event that creditors object if the plan meets the requirements of chapter 12.[111]

The plan confirmation requirements are modeled after those of chapter 13.[112] The good faith provision of chapter 13[113] is retained in chapter 12[114] and cases interpreting good faith under chapter 13 are likely to be applicable to "good faith" issues in chapter 12 cases.[115] A

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[104] 11 U.S.C. § 1226 (Supp. IV 1986).

[105] 11 U.S.C. § 1208(c)(4) (Supp. IV 1986).

[106] 11 U.S.C. § 1326(a)(1) (Supp. IV 1986).

[107] 11 U.S.C. § 1224 (Supp. IV 1986).

[108] *Id.*

[109] H.R. Rep. No. 958, 99th Cong., 2d Sess. 48 (1986).

[110] 11 U.S.C. § 1224 (Supp. IV 1986). *See supra* note 78.

[111] *See supra* note 78 and accompanying text.

[112] *Compare* 11 U.S.C. § 1325 (1982 & Supp. IV 1986)(chapter 13 plan confirmation requirements) *with* 11 U.S.C. § 1225 (Supp. IV 1986)(chapter 12 plan confirmation requirements).

[113] *See* 11 U.S.C. § 1325(a)(3) (1982)(court shall confirm plan if proposed in good faith and not by any means forbidden by law).

[114] 11 U.S.C. § 1225(a)(3) (Supp. IV 1986).

[115] *See generally* Note, *Bankruptcy: Good Faith and the Zero Payment Plan in Chapter 13*, 69 Ky. L.J. 327, 351-355 (1980-81)(listing of cases and jurisdictions discussing good faith under chapter 13).

specific goal of chapter 12 is for the plan to be feasible and in the best interests of creditors. Generally, this means that the plan must give holders of unsecured claims, as of the effective date of the plan, not less than they would receive if the farmer's property were liquidated in chapter 7 bankruptcy.[116] Before a chapter 12 plan will be confirmed by the court, secured claims must be paid the value of their collateral.[117] The requirements for the treatment of holders of secured claims under chapter 12 are identical to those in chapter 13.[118] Thus, chapter 13 case law regarding section 1325(a)(5) should also be applicable to section 1225(a)(5). The bankruptcy court will confirm the plan if holders of the secured claims accept the plan.[119] If the secured creditors do not accept the plan, the plan must provide for the retention of the lien securing the claim[120] or the debtor must surrender the property securing the claim to the creditor.[121]

Under section 1225(a)(5), a family farmer may "write down" the mortgage on the farm to the value of the farm and restructure that debt, which will be secured by a lien on the amount of the value of the property.[122] The debt may be amortized so that the lienholder will receive the present value of the secured claim.[123] For example, if the amount of the lien is $1,000,000 and the present value of the farm is $500,000 then the debtor will be required to satisfy a secured claim of $500,000 and the $500,000 unsecured claim will be paid its proportionate share of net farm revenues under the chapter 12 plan, which will normally be for a period of not less than three years.[124]

If the trustee or the holder of an allowed unsecured claim objects to confirmation of the chapter 12 plan, the plan must provide for payment of the claim in full, or in the alternative provide that all of the debtor's disposable income be paid into the plan for three years, or for

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[116] 11 U.S.C. § 1225(a)(4) (Supp. IV 1986). This is the same "best interest of creditors" test as found in chapter 13. 11 U.S.C. § 1325(a)(4) (1982).

[117] 11 U.S.C. § 1225(a)(5) (Supp. IV 1986).

[118] *Compare* 11 U.S.C. § 1225(a)(5) (Supp. IV 1986) *with* 11 U.S.C. § 1325(a)(5) (1982)(identical language in both sections).

[118] 11 U.S.C. § 1225(a)(5)(A) (Supp. IV 1986).

[120] 11 U.S.C. § 1225(a)(5)(B)(i) (Supp. IV 1986).

[121] 11 U.S.C. § 1225(a)(5)(C) (Supp. IV 1986). Chapter 12 contains no § 1111(b) election for holders of secured claims. *See supra* note 13 and accompanying text. *See also* J. ANDERSON & J. MORRIS, *supra* note 18, at § 6.10 (explaining treatment of secured and partially secured creditors in chapter 12 cases).

[122] J. ANDERSON & J. MORRIS, *supra* note 18, at § 6.10.

[123] *Id.*

[124] *See* 11 U.S.C. § 1225(a)(4) (Supp. IV 1986) and 11 U.S.C. § 1225(b)(1)(B) (Supp. IV 1986)(applicable provisions for undersecured creditors).

up to five years if court approval is obtained.[125] Disposable income is defined as income received by the debtor less what is "reasonably necessary" for maintenance or support of the debtor or the debtor's dependents or for payments of expenditures necessary for the continuation, preservation and "operation of the debtor's business."[126] The statement of the congressional conferees indicates that "operation of the debtor's business" includes the farming operation itself as well as minor nonfarming businesses in which the farmer may be engaged.[127]

Finally, the debtor must produce sufficient evidence that he or she will be able to make all payments under the plan and comply with the terms of the plan.[128]

6. Effect of Confirmation

A confirmed chapter 12 plan is binding on the debtor, creditors, equity security holders and general partners.[129] Except as otherwise provided in the plan or in the confirmation order, the confirmation vests all of the property of the estate in the debtor free and clear of any claim or interest of any creditor provided for by the plan.[130]

Concerned with the farmer's ability to obtain post-confirmation credit, the conferees also authorized the allowance of post-confirmation credit as is allowed in a chapter 13 case.[131] Post-confirmation financing may be secured by assets or property that has revested in the debtor to the extent it is not encumbered by the plan or order of confirmation.[132]

At any time after confirmation, but before the completion of payments under the plan, a chapter 12 plan may be modified on request of the debtor, the trustee, or the holder of an allowed unsecured claim.[133] The modification may increase or reduce the amount of payments on claims of a class, may extend or reduce the time for payments, or may

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[125] 11 U.S.C. § 1225(b)(1)(B) (Supp. IV 1986). *Contra* 11 U.S.C. § 1325(b)(1)(B) (Supp. IV 1986)(section does not authorize payment to be made for over three year period).

[126] 11 U.S.C. § 1225(b)(2) (Supp. IV 1986). *Cf.* 11 U.S.C. § 1325(b)(2) (Supp. IV 1986)(identical to section 1225(b)(2)).

[127] H.R. REP. No. 958, 99th Cong., 2d Sess. 50 (1986).

[128] 11 U.S.C. § 1225(a)(6) (Supp. IV 1986).

[129] 11 U.S.C. § 1227(a) (Supp. IV 1986).

[130] 11 U.S.C. § 1227(b) (Supp. IV 1986); 11 U.S.C. § 1227(c) (Supp. IV 1986).

[131] *See* H.R. REP. No. 958, 99th Cong., 2d Sess. 50, 51 (1986)(explaining that § 1227 authorizes post-confirmation credit as is allowed by equivalent § 1327 in chapter 13).

[132] *Id.* Section 1227 prevents the problem of potential creditors refusing to extend post-petition credit by arguing that the stay prevents any collection activity against property of the estate. *Id.*

[133] 11 U.S.C. § 1229(a) (Supp. IV 1986).

alter the amount of distribution to a creditor to the extent necessary to take account of any payment other than under the plan.[134] The plan content requirements of section 1222 and the confirmation requirements of section 1225 apply to the modified plan.[135]

Section 1229 prohibits a modified plan from providing for payments over a period that expires later than three years after the time the first payment under the originally confirmed plan was due, unless the court approves a longer term of up to five years.[136] Furthermore, there are no exceptions to the three to five year limitation for debts under sections 1222(b)(5) and 1222(b)(9) with modified plans. If section 1229(c) is read literally, the secured claims to be paid under section 1222(b)(9) could not be further modified after confirmation. A provision in chapter 12 which would allow post-confirmation modifications concerning secured claims could possibly obviate this potential problem. The chapter 12 debtor receives the same state and local tax treatment as a chapter 11 debtor.[137]

7. Discharge

Upon completion of the payments for unsecured debts, the debtor receives a discharge.[138] However, the chapter 12 discharge is not as broad as that provided by chapter 13. The non-dischargeable debts specified in section 523(a) and long term debts on which the last payment is due are excluded from the chapter 12 discharge.[139]

The section 727(a) provisions which would cause a discharge to be denied under chapter 7[140] do not apply in a chapter 12 case. It is possible that facts which would support a denial of a discharge under 727(a) could be considered by the bankruptcy court when determining whether the plan was proposed in "good faith" under section 1225(a)(3).[141]

Chapter 12 contains a provision for hardship discharge similar to that in chapter 13.[142] After the debtor is discharged, the court will ter-

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[134] *Id.*

[135] 11 U.S.C. § 1229(b) (Supp. IV 1986).

[136] 11 U.S.C. § 1229(c) (Supp. IV 1986).

[137] 11 U.S.C. § 1231 (Supp. IV 1986).

[138] 11 U.S.C. § 1228(a) (Supp. IV 1986).

[139] 11 U.S.C. § 1228(a)(1) (Supp. IV 1986); 11 U.S.C. § 1228(a)(2) (Supp. IV 1986).

[140] *See* 11 U.S.C. § 727(a) (1982 & Supp. IV 1986)(listing factors which would cause a discharge to be denied under chapter 7).

[141] *See supra* notes 113-115 and accompanying text.

[142] *Compare* 11 U.S.C. § 1228(b) (Supp. IV 1986) *with* 11 U.S.C. § 1328(b) (1982).

minate the services of any trustee serving in the case.[143] The entry of discharge will also terminate the automatic stay.[144]

III. Conclusion

The provisions in the new chapter 12 will aid in the preservation of the family farm and, at the same time, will maintain the integrity of the bankruptcy system by ensuring that farm creditors are fairly protected. Fostering the congressional policy of reorganization as opposed to liquidation, Congress passed chapter 12 to remedy the farmer's inability to successfully reorganize under the existing Bankruptcy Code. However, this legislation is only a stop gap measure for the farm crisis, not a cure. Many farmers in the United States are in a precarious financial position overburdened with debt.

There are many reasons for this unfortunate financial situation. One reason is that declining market prices for crops are insufficient to supply the rapidly increasing amount of capital necessary to conduct the business of farming and to pay production costs. The inability to create a reasonable cash flow has caused a significant depreciation of agrarian land value to a fraction of its previous fair market value and initial cost. Furthermore, farming is vulnerable to problems beyond its control, such as weather conditions, insect infestation and natural catastrophes which create unpredictable and often disastrous financial problems for farmers. An additional factor is the federal government's role in the future of the American farmer. The federal government substantially controls the future for American farmers by its domestic and foreign policies concerning purchases and sales of crops. The borrowing programs instituted over recent years to provide low interest loans to farmers have had less than successful results. These programs encouraged borrowing but have led to an unprecedented number of overleveraged farmers.

All of these circumstances have contributed to the dire financial consequences that many farmers are now facing. The financial crisis of the American farmer has triggered an astronomic number of farm foreclosures. A flooded market of foreclosed farms will have a disastrous effect on the collapsing farm community and result in a loss of equity for farmers and their creditors. Congress must find alternative solu-

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[143] 11 U.S.C. § 1228(e) (Supp. IV 1986).

[144] 11 U.S.C. § 362(c)(2)(C) (Supp. IV 1986).

tions through comprehensive economic farm legislation to help the farm industry regain its strength as an integral part of the American economy.

Robin Cochran

RECENT DECISIONS

Civil Rights — Attorney's Fees — Prevailing Party in an Administrative Proceeding to Enforce Rights Protected by Title VI Cannot Recover Attorneys' Fees in an Independent Action Under Section 1988 Brought Solely to Recover Attorneys' Fees

Respondents[1] filed an action in the United States District Court for the Middle District of North Carolina to recover attorney's fees[2] incurred in administrative proceedings[3] against petitioner.[4] Respondents alleged civil rights violations in an administrative complaint filed with the Department of Transportation[5] and in an unrelated action

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[1] Respondents were two unincorporated associations, Residents of Crest Street Community and Save Our Church and Community Committee, who represented residents of a predominantly black neighborhood that was the proposed site of a new federally-funded highway. North Carolina Dep't of Transp. v. Crest Street Community Council, 107 S. Ct. 336, 338 (1986).

[2] *Id.* Respondents sought attorney's fees under 42 U.S.C. § 1988 (1976) which provides for attorney's fees to be awarded to the prevailing party in any action or proceeding to enforce a provision of Title VI of the Civil Rights Act of 1964. *Crest Street*, 107 S. Ct. at 339.

[3] *Crest Street*, 107 S. Ct. at 339. Respondents filed an administrative complaint with the United States Department of Transportation, a federal administrative body, challenging petitioners proposed highway through the Crest Street neighborhood. *Id.* Counsel for respondents spent more than 12,000 hours over a five year span preparing for and participating in the negotiations as well as assisting the Department of Transportation in its investigation. *Id.* The administrative agency found that petitioners' actions probably had violated respondents' civil rights whereupon the parties entered into negotiations to secure a plan that would mitigate the damage to respondents' neighborhood. *Id.* A final agreement was reached after more than two years of negotiations. *Id.*

[4] *Id.* at 338. Petitioner, the North Carolina Department of Transportation, was the entity that proposed to construct the new highway. *Id.*

[5] *Id.* The administrative complaint filed with the U.S. Department of Transportation alleged a breach of Title VI of the Civil Rights Act of 1964 by petitioners, proposing to extend a federally-funded highway through respondents' predominantly black neighborhood. *Id.* The pertinent part of Title VI prohibited "any program or activity receiving

that was eventually dismissed in federal court.[6] In the resulting administrative negotiations with petitioner, respondents prevailed.[7] Respondents then filed a separate action solely to recover attorney's fees under the Civil Rights Attorney's Fees Awards Act of 1976.[8] On cross-motions for summary judgment, the federal district court granted the motion of the petitioner and dismissed the action.[9] The United States Court of Appeals for the Fourth Circuit reversed.[10] On writ of certiorari, the United States Supreme Court, *held*, reversed. Where a Title VI civil rights claim is settled in an administrative proceeding and a subsequent independent action is brought by the prevailing party to

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Federal financial assistance from discriminating on the basis of race, color, or national origin." *Id.*

[6] *Id.* In an unrelated proceeding, petitioner moved to dissolve an injunction that had halted construction of the highway. *Id.* ECOS Inc., an ecological organization, procured the injunction, which was to last until the parties building the highway complied with certain statutes. *Id.* After petitioner moved to dissolve the injunction, respondents moved to intervene in the action and filed a complaint alleging Title VI violations. *Id.* at 338. The district court never ruled on respondents' motion to intervene, but the court entered a consent judgment that dismissed respondents' complaint conditioned on petitioner implementing the final plan that was reached during negotiations. *Id.* The final plan was reached while respondents' motion to intervene was pending in the district court, prior to the dismissal. *Id.*

[7] *Id.* The final mitigation plan that was reached in negotiations favored the respondents' position and petitioner agreed to relocate the proposed highway. *Id.*

[8] *Id.* The Act states: "[i]n an action or proceeding to enforce a provision of . . . Title VI of the Civil Rights Act of 1964, the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs." Civil Rights Attorney's Fee Awards Act of 1976, 42 U.S.C. § 1988 (1976). The respondents relied on this language in the statute, although no request for attorney's fees was filed in the administrative complaint. *Crest Street*, 107 S. Ct. at 338.

[9] *Crest Street*, 107 S. Ct. at 338. *See* Crest Street Community Council, Inc. v. North Carolina Dep't of Transp., 598 F. Supp. 258, 265-67 (M.D.N.C. 1984), *rev'd*, 769 F.2d 1025 (4th Cir. 1985), *rev'd*, 107 S.Ct. 336 (1986). The district court denied attorney's fees to the respondents reasoning that since exhaustion of state administrative remedies is not required under Title VI, respondents had an option to file the complaint in court and that only a court may award attorney's fees. *Crest Street*, 598 F. Supp. at 265-66. The district court denied attorney's fees in the ECOS action based on the theory that respondents were never allowed to intervene in the action so they failed to become part of the action. *Id.* at 263.

[10] Crest Street Community Council, Inc. v. North Carolina Dep't of Transp., 769 F. 2d 1025, 1033-34 (4th Cir. 1985), *rev'd*, 107 S.Ct. 336 (1986). The Fourth Circuit allowed the recovery of attorney's fees for the prevailing party subsequent to the filing of an administrative complaint. *Id.* The Fourth Circuit, in a holding contrary to other circuits, reasoned that Title VI actions, similar to Title VII actions, relied on enforcement primarily through administrative proceedings, and denying attorney's fees to the prevailing party would result in unfair consequences based solely on the fact that the party resolved the conflict without court action. *Id.* at 1033.

recover attorney's fees, attorney's fees may not be recovered under section 1988. *North Carolina Dep't of Transp. v. Crest St. Community Council*, 107 S. Ct. 336 (1986).

Historically, American law disallowed attorney's fees based on the American rule — the concept that absent statutory authorization each litigant paid his own attorney's fees, regardless of the trial's outcome.[11] In 1796, the United States Supreme Court first enunciated the rule in *Arcambel v. Wiseman*,[12] in which a lower court's decision to award attorney's fees was reversed.[13] Subsequently, the Court routinely denied similar requests based on the *Arcambel* interpretation of the American rule.[14] As recently as 1967, the Supreme Court affirmed adherence to the American rule in *Fleischmann Drilling Corp. v. Maier Brewing Co.*[15] The *Fleischmann* Court refused to award attorney's fees because the statute under which the action was brought failed to expressly provide for recovery of attorney's fees.[16]

One of the few statutes that provided for recovery of attorney's fees by successful litigants was the Civil Rights Act of 1964,[17] which

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[11] *See generally* Comment, *Court Awarded Attorney's Fees and Equal Access to the Courts*, 122 U. PA. L. REV. 636, 637-39 (1974)(background of American rule contrasted with English rule, which most countries apply, allowing attorney's fees to prevailing parties in lawsuits).

[12] 3 U.S. (3 Dall.) 306 (1796).

[13] *Id.* at 306. The Supreme Court affirmed the decree of the Circuit Court for the District of Rhode Island and awarded damages. *Id.* The lower court had awarded attorney's fees as part of the damages. *Id.* The Court reasoned that the general practice of the United States opposed awards of attorney's fees, and stated that the practice would be respected until changed by statute. *Id.*

[14] *See, e.g.*, Hall v. Cole, 412 U.S. 1, 4 (1973)(American rule disfavors allowance of attorney's fees); Stewart v. Sonneborn, 98 U.S. 187, 197 (1878)(attorney's fees not included as normal damages because fees were not proximately caused by defendant's action); Oelrichs v. Spain, 82 U.S. (15 Wall.) 211, 231 (1872)(restating American rule and discussing potential for abuse if attorney's fees were awarded); Day v. Woodworth, 54 U.S. (13 How.) 363, 372 (1851)(Supreme Court concluded that attorney's fees were not allowed as damages by law).

[15] 386 U.S. 714 (1967).

[16] *Id.* at 714-20. *Fleischmann* was a trademark case brought under the Lanham Act, which failed to provide for recovery of attorney's fees. *Id.* at 714. The Court followed the rule enunciated in *Arcambel* stating that the Court would not imply a remedy where Congress created a statute that expressly provided for other remedies. *Id.* at 720. The Court further reasoned that since a victory in a lawsuit is far from assured, some parties would be discouraged from filing suit if they thought an award of attorney's fees would be levied against them upon a loss. *Id.* at 718.

[17] 42 U.S.C. § 2000a-3(b) (1976). Title II provides for attorney's fees in actions filed under that subchapter. 42 U.S.C. § 2000e-5(k) (1976). Additionally, Title VII provides for attorney's fees in actions or proceedings under that subchapter. *Id.*

allowed attorney's fees in certain categories of civil rights litigation.[18] One year after deciding *Fleischmann*, the Court, in *Newman v. Piggie Park Enterprises*,[19] considered whether to allow attorney's fees to a party who obtained an injunction under Title II of the Civil Rights Act of 1964.[20] In *Piggie Park*, petitioners filed a class action suit under Title II[21] to enjoin racial discrimination at public restaurants.[22] In approving the award of attorney's fees,[23] the Court reasoned that citizens brought suits as private attorney generals to enforce their civil rights under Title II,[24] and awarding attorney's fees would encourage individuals to seek vindication of their rights in court actions.[25]

Courts widely accepted the private attorney general theory and expanded it to award attorney's fees even where there was no statutory authorization for such an award.[26] In 1975, however, the discretionary

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[18] *See* Booker v. Brown, 619 F.2d 57, 61 (10th Cir. 1980) (attorney's fees awarded under Title VII for services rendered at administrative proceedings as well as judicial proceedings); Miller v. Amusement Enters., Inc., 426 F.2d 534, 538-39 (5th Cir. 1970) (under Title II reasonable attorney's fees are allowed as part of costs).

[19] 390 U.S. 400 (1968).

[20] *Id.* at 401. The relevant portion of Title II states: "[i]n this subchapter, the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs, and the United States shall be liable for costs the same as a private person." 42 U.S.C. § 2000a-3(b) (1976).

[21] *Piggie Park*, 390 U.S. at 400-01. This action was filed under 42 U.S.C. § 2000a-3(a)(1976). *Piggie Park*, 390 U.S. at 400. This section provides a civil remedy for discrimination or segregation in places of public accommodation. 42 U.S.C. § 2000a-3(a)(1976).

[22] *Piggie Park*, 390 U.S. at 400-01. Respondent Piggie Park Enterprises owned five drive-in restaurants and one sandwich shop, all of which were racially segregated. *Id.*

[23] *Id.* at 402-03. The Court based the decision on the language of § 2000a-3(b), reasoning that when a plaintiff obtained an injunction he received no monetary compensation so the plaintiff was entitled to attorney's fees unless special circumstances rendered such an award unjust. *Id.* at 403.

[24] *Id.* at 403. The Supreme Court reasoned that an injunction benefits not only that party but also the public interest and thus the party who brought suit did so as a private attorney general. *Id.* If the courts refused to award attorney's fees in these cases, then pursuance of public rights by private individuals would be limited. *Id.*

[25] *Id.* The Court noted that Congress enacted the attorney's fees provision to encourage private citizens to bring racial discrimination suits, knowing that if they prevailed attorney's fees would be awarded to them. *Id.*

[26] *See, e.g.*, Albemarle Paper Co. v. Moody, 422 U.S. 405, 415 (1975)(attorney's fees allowed under Title VII of Civil Rights Act of 1964 where fees were expressly provided for); Northcross v. Memphis Bd. of Educ., 412 U.S. 427, 428 (1973)(successful plaintiffs in desegregation action awarded attorney's fees); Mills v. Electric Auto-Lite Co., 396 U.S. 375, 396 (1970)(attorney's fees allowed because private stockholders' actions benefitted all shareholders); Lee v. Southern Homes Sites Corp., 444 F.2d 143, 148 (5th Cir. 1971)(court applied private attorney general theory where no express statutory authority provided for attorney's fees); Lea v. Cone Mills Corp., 438 F.2d 86, 88 (4th Cir.

power of courts in awarding attorney's fees[27] was curtailed by the United States Supreme Court decision in *Alyeska Pipeline Service v. Wilderness Society*.[28] In *Alyeska*, environmental groups[29] obtained an injunction blocking construction of a pipeline because such a land use violated the Mineral Leasing Act.[30] After the litigation terminated, the plaintiff sought attorney's fees.[31] The Supreme Court held that a prevailing party in federal litigation, including civil rights cases, was not entitled to attorney's fees absent statutory authorization.[32] In response to the *Alyeska* decision,[33] Congress passed the Civil Rights Attorney's Fees Awards Act of 1976 (CRAFAA),[34] which authorized an award of attorney's fees to prevailing parties[35] in civil rights actions enumerated

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1971)(court awarded attorney's fees where racial discrimination was enjoined).

[27] *See generally* Derfner, *One Giant Step: The Civil Rights Attorney's Fees Awards Act of 1976*, 21 St. Louis U.L.J. 441, 442 (1977)(fee awards almost automatic under court's discretion).

[28] 421 U.S. 240 (1975).

[29] *Id.* at 241. Respondents were Wilderness Society, Environmental Defense Fund, Inc., and Friends of the Earth. *Id.*

[30] *Id.* at 242. The petitioner was Alyeska Pipeline Service Co. *Id.* at 241. Respondents were granted a preliminary injunction against issuance of certain land use permits to Alyeska which would have violated the Mineral Leasing Act of 1920, 30 U.S.C. § 185 (1982), if issued. *Alyeska*, 421 U.S. at 242.

[31] *Alyeska*, 421 U.S. at 245. The Mineral Leasing Act was amended by Congressional legislation that allowed granting of the land use permits sought by Alyeska. *Id.* at 244-45. Respondents requested an award of attorney's fees although no statute authorized such an award. *Id.* at 245.

[32] *Id.* at 269-71. The Supreme Court rejected the private attorney general theory, on which the Court of Appeals based its decision that allowed recovery of attorney's fees. *Id.* The Court reasoned that Congress reserved the exclusive power to create statutory exceptions to the American Rule, and therefore, attorney's fees granted by federal courts were appropriate only where Congress had indicated they would be. *Id.*

[33] *See* S. Rep. No. 1011, 94th Cong., 2d Sess. 1, *reprinted in* 1976 U.S. Code Cong. & Admin. News 5908, 5909 (Congress expressed a desire to protect litigants' ability to enforce civil rights laws).

[34] Pub. L. No. 94-559, 90 Stat. 2641 (1976)(codified at 42 U.S.C. § 1988 (1976)).

[35] Courts have awarded fees to prevailing defendants only in limited circumstances. *See* Christiansburg Garment Co. v. Equal Employment Opportunity Comm'n, 434 U.S. 412, 418-22 (1978)(attorney's fees allowed to defendants in Title VII action only when plaintiffs claim was frivolous, unreasonable, or groundless because equitable considerations that courts relied on in awarding attorney's fees to plaintiffs were absent in situations where attorney's fees were to be awarded to defendants); Carrion v. Yeshiva Univ., 535 F. 2d 722, 727 (2d Cir. 1976)(award to defendant not permitted where he succeeds absent meritless claim by plaintiff); United States Steel Corp. v. United States, 519 F. 2d 359, 363 (3rd Cir. 1975)(defendant resisted Commission's demand for documents but court denied attorney's fees to defendant because Commission's claim was not unfounded, meritless, frivolous, or vexatious).

in section 1988.[36] In passing the CRAFAA, Congress expressed a desire for uniformity in the awarding of attorney's fees in civil rights actions.[37] Thus, the practical effect of the CRAFAA was to modify the strict rule of *Alyeska* so that attorney's fees would be awarded to prevailing parties in civil rights actions as incentive for citizens to vindicate their protected rights.[38]

In *New York Gaslight Club, Inc. v. Carey*,[39] the Supreme Court considered the issue of whether work done in administrative proceedings mandated by Title VII[40] justified an award of attorney's fees to the prevailing party.[41] Respondent prevailed on an employment discrimination claim filed with a state agency but was not awarded attorney's fees.[42] Subsequently, respondent filed suit in federal district

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[36] 42 U.S.C. § 1988 (1976). Section 1988 provides in pertinent part:

> [I]n any action or proceeding to enforce a provision of sections 1981, 1982, 1983, 1985, and 1986 of this title, title IX of Public Law 92-318 [20 U.S.C. § 1681 *et seq.* . . .], or title VI of the Civil Rights Act of 1964 [(42 U.S.C. § 2000d *et seq.*], the court, in its discretion, may allow the prevailing party, other than the United States, a reasonable attorney's fee as part of the costs.

42 U.S.C. § 1988 (1976).

[37] Senate Report, *supra* note 34, at 4, *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS at 5909. Congress sought to implement a uniform system of awarding attorney's fees in civil rights cases to counteract the gaps in the systems created by the *Alyeska* decision. *Id.*

[38] *See* Howard, *Attorney's Fees Under Civil Rights Litigation — An Evasive Standard*, 20 IDAHO L. REV. 635, 641 (1984)(legislative purpose behind § 1988 encouraged use of the private attorney general theory).

[39] 447 U.S. 54 (1980).

[40] 42 U.S.C. § 2000e-5(c)-(d) (1976). Title VII requires that prior to filing a civil action in federal court, an employee must first exhaust his available administrative remedies. *Id. See* Civil Rights Act of 1964, §§ 706(f), 717(c) (codified as amended at 42 U.S.C. §§ 2000e-5(f), 2000e-16(c) (1976); *see also* Brown v. Gen. Serv. Admin., 425 U.S. 820, 835 (1976) (administrative remedy for Title VII discrimination suit). *But cf.* Chowdhury v. Reading Hosp. & Medical Center, 677 F.2d 317, 321 (3d Cir. 1982), *cert. denied*, 463 U.S. 1229 (1983)(administrative remedies not required to be exhausted under Title VI); Swan v. Stoneman, 635 F.2d 97, 103 (2d Cir. 1980)(exhaustion requirement not given strict application to state administrative proceedings). *See generally* Note, *Administrative Law: Recovery of Attorney's Fees by Prevailing Plaintiffs in Title VII Actions*, 33 OKLA. L. REV. 98, 102 (1980)(federal administrative proceeding required as prerequisite to filing of Title VII suit).

[41] *Carey*, 447 U.S. at 61. The Court referred to a prevailing party as a party who prevailed in state administrative or judicial proceedings. *Id.*

[42] *Id.* at 57. The New York State Division of Human Rights found that respondent probably had been discriminated against and after administrative hearings ordered petitioner to pay back wages and to offer respondent employment. *Id.* However, no attorney's fee was awarded. *Id.*

court where the action was dismissed[43] and the request for attorney's fees was denied.[44] The Supreme Court extended the scope of its prior holdings that allowed attorney's fees only for civil rights claims adjudicated in federal administrative proceedings,[45] and awarded attorney's fees to a prevailing party in state administrative and judicial proceedings,[46] based on the Court's interpretation of the statute under which the action was brought.[47]

In 1982, the Court, in *White v. New Hampshire Department of Employment Security*,[48] considered whether a post-judgment request for attorney's fees under section 1988[49] was a collateral issue and thus could be brought in an action separate from the original trial on the merits.[50] In *White*, petitioner's request for attorney's fees was filed af-

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[43] *Id.* at 58-59. Respondent filed suit in a federal district court and asserted discrimination claims under Title VII. *Id.* at 58. The district court dismissed the action after a pretrial conference without ruling on respondent's application for attorney's fees. *Id.* at 59.

[44] *Id.*

[45] *See* Parker v. Califano, 561 F.2d 320, 323 (D.C. Cir. 1977)(attorney's fees awarded for work done in federal administrative proceedings as well as federal judicial proceedings); Foster v. Boostin, 561 F.2d 340, 343 (D.C. Cir. 1977)(plaintiff allowed to recover attorney's fees under Title VII where majority of billable time was spent in legislative process). *Carey* was the first case in which the Supreme Court awarded attorney's fees for work preformed in connection with state administrative proceedings under Title VII. *Carey*, 447 U.S. at 60.

[46] *Carey*, 447 U.S. at 71. The Court concluded that parties who prevailed in state administrative proceedings were allowed recovery of attorney's fees that arose from work done in conjunction with those proceedings. *Id.*

[47] *Id.* at 60-62. The Court relied on the specified wording of § 706(k) that stated "[i]n any action or proceeding" under Title VII, reasonable attorney's fees are allowable at the court's discretion. *Id.* at 61. The Court reasoned that the word "proceedings" indicated that attorney's fees incurred in administrative proceedings were allowable. *Id.* The Court further broadened the effect of the statute by reasoning that the word "any" included state or federal proceedings. *Id.* at 62. The Court compared this wording with that of Title II, which depended on court actions for enforcement, and noted that Congress omitted the word "proceedings" in Title II. *Id.* at 61. As a result of this analysis, the Court concluded that "proceedings" in § 706(k) included state and federal administrative proceedings. *Id.* at 62. *See* Smith v. Califano. 446 F. Supp. 530, 531 (D.C. Cir. 1978)(Title VII permitted attorney's fees to party who prevailed at administrative level receiving complete relief there); Burch v. Goodyear Tire and Rubber Co., 554 F.2d 633, 635 (4th Cir. 1977)(court allowed attorney's fees for work done in administrative proceedings on remand). *See generally* Cubita, *Awards of Attorney's Fees in the Federal Courts*, 56 ST. JOHN'S L. REV. 277, 308-12 (1982)(general background for attorney's fees awarded in federal or state administrative proceedings).

[48] 455 U.S. 445 (1982).

[49] *See supra* note 36 and accompanying text.

[50] *White*, 455 U.S. at 451. The Court determined that a request for attorney's fees

ter a judgment had been entered for petitioner on a consent decree.[51] The *White* Court reviewed its analysis in *Carey*, and found that a post-judgment request for attorney's fees could be brought under section 1988 as a separate issue from the action at trial.[52] In 1983, the Court decided *Hensley v. Eckerhart*,[53] concluding that a partially prevailing party could recover attorney's fees under section 1988 for work done on unsuccessful claims in civil rights actions.[54] In *Hensley*, plain-

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under § 1988 was not part of the main cause of action and therefore Federal Rule of Civil Procedure 59(e) was inapplicable. *Id.* at 452. Rule 59(e) provided that a motion to alter or amend a judgment had to be filed within 10 days after the judgment was entered. *Id.* at 445 n.1. *See* Knighton v. Watkins, 616 F.2d 795, 797 (5th Cir. 1980)(party entering request for attorney's fees sought not to change judgment but sought what was due because of judgment so Rule 59(e) held inapplicable).

[51] *White*, 455 U.S. at 447-48. Petitioner's motion for attorney's fees was filed separately, four and one-half months after the final judgment was entered. *Id.* The district court approved of the consent agreement entered into by the parties and entered judgment accordingly. *Id. See, e.g.*, Maher v. Gagne, 448 U.S. 122, 130 (1980)(party considered prevailing when substantial part of relief sought in complaint was included in consent decree); S.REP. No. 1011, 94th Cong., 2d Sess. 5, *reprinted in* 1976 U.S. CODE CONG. & ADMIN. NEWS 5908, 5912 (party may be considered prevailing even if party's rights were vindicated without formal judicial relief). *See generally* Miller, *The Scope of the Civil Rights Attorney's Fees Awards Act After Maine v. Thiboutot, Maher v. Gagne, and Supreme Court of Virginia v. Consumers Union*, 66 IOWA L. REV. 1301, 1317-18 (1981)(award of attorney's fees to prevailing party in settlement agreements encourages out of court settlements and promotes judicial efficiency).

[52] *White*, 455 U.S. at 451-52. After reviewing the *Carey* holding, the Court concluded that a post-judgment request for attorney's fees raised an issue separate from those considered at trial because to award attorney's fees the Court must look to who prevailed in the action, and not to substantive trial issues. *Id.*

[53] 461 U.S. 424 (1983).

[54] *Id.* at 440. The Court noted that the CRAFAA failed to establish a standard for setting the amount of a fee award where plaintiff had achieved only partial success. *Id.* at 431-32. Prior to the *Hensley* decision, courts used varying standards to determine who was a prevailing plaintiff. *Id.* at 429-32. *See, e.g.*, Busche v. Burkee, 649 F.2d 509, 521 (7th Cir. 1981), *cert. denied* 454 U.S. 897 (1981)(holding that prevailing party was one who prevailed on central issue); Nadeau v. Helgemoe, 581 F.2d 275, 278-79 (1st Cir. 1978)(plaintiffs considered prevailing if they succeed in any significant issue which achieved some benefit sought by party who brought suit); Swann v. Charlotte-Mecklenburg Bd. of Educ., 66 F.R.D. 483, 484 (W.D. N.C. 1975)(fees awarded to party who obtained excellent results despite failure to succeed on all counts). *But see, e.g.*, Hanrahan v. Hampton, 446 U.S. 754, 759 (1980)(party who prevails on purely procedural issues is not entitled to attorney's fees); Bartholomew v. Watson, 665 F.2d 910, 914 (9th Cir. 1982)(refused to allow fees for any work done on unsuccessful claims). *See generally* Note, *Attorney's Fees — In An Action Brought on the Basis of the Deprivation of Constitutionally Protected Civil Rights, The Extent of a Plaintiff's Success is a Crucial Factor in Determining The Proper Amount of an Award of Attorney's Fees Under the Civil Rights Attorney's Fees Awards Act of 1976, 42 U.S.C. § 1988*, 34 DRAKE L. REV.

tiffs prevailed on five of six claims[55] and subsequently filed for attorney's fees under the CRAFAA.[56] The Court remanded for further proceedings,[57] but enunciated a test that allowed attorney's fees to a partially prevailing plaintiff based on the the extent of plaintiffs success.[58] The test was created to give lower courts workable guidelines[59] when determining the amount of attorney's fees to which a plaintiff in a civil rights action was entitled.[60]

In *Webb v. Dyer County Board of Education*,[61] the Court limited *Carey* by refusing to award attorney's fees incurred in state administrative proceedings where not authorized by federal statute.[62] In *Webb*, petitioner was awarded attorney's fees that accrued in preparation of a

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241, 242 (1984-85)(Court in *Hensley* attempted to create guidelines by which to award attorney's fees to plaintiffs who achieved limited success).

[55] *Hensley*, 461 U.S. at 427-28. The Court found constitutional violations in five of six areas. *Id.*

[56] *Id.* at 428. Plaintiffs filed for an award of attorney's fees based on 2,985 hours that counsel had worked. *Id.* The plaintiffs brought their claim under section 1988. *Id.*

[57] *Id.* at 440. Both the district court and the Eighth Circuit allowed recovery of attorney's fees for hours spent on all the claims including unsuccessful claims. *Id.*at 428.

[58] *Id.* at 440. The Court found that the extent of a plaintiff's success was the most important factor in determining attorney's fees. *Id.* The *Hensley* Court noted that three categories existed for purposes of granting a fee award: (1) work done on unsuccessful claims was not included in the award; (2) work done on claims related to those grounds upon which substantial relief was granted was included in the award, even if not every contention was adopted; and, (3) where a party achieved limited success, the amount of fees awarded was reasonably related to the amount of success obtained. *Id.*

[59] *Id.* at 436-37. The Court endeavored to give lower courts a basis for awarding attorney's fees when a plaintiff obtained limited success. *Id.* However, the Court emphasized that the district courts had discretion in determining the amount of the fee. *Id.*; *cf.* Johnson v. Georgia Highway Express, Inc., 488 F.2d 714, 717-19 (5th Cir. 1974)(12 factors were enumerated which lower courts employed in determining reasonableness of awards of attorney's fees).

[60] *Hensley*, 461 U.S. at 432. The *Hensley* Court set new standards by which attorney's fees were to be awarded, but allowed lower courts to continue applying the *Johnson* factors to each case with an emphasis on the factors that related to the amount involved and the result obtained for the client. *Id.* at 433-37.

[61] 471 U.S. 234 (1985).

[62] *Id.* at 236. *See also* Maine v. Thiboutot, 448 U.S. 1, 11 (1980)(attorney's fees awarded whether action under § 1988 was filed in federal or state court); NAACP v. Wilmington Medical Center, Inc., 689 F.2d 1161, 1171 (3d Cir. 1982), *cert. denied*, 460 U.S. 1052 (1982)(attorney's fees incurred in administrative proceedings to enforce Title VI were allowed because administrative proceedings were causally linked with prosecution of the complaint); Brown v. Culpepper, 559 F. 2d 274, 278 (5th Cir. 1977)(standards applicable to Titles II, VII were applied to § 1988 to encourage individuals injured by racial discrimination to seek relief).

district court action,[63] but was denied attorney's fees that accrued in prior administrative hearings.[64] The *Webb* Court denied the award on grounds that state administrative hearings were not "proceedings to enforce" section 1983.[65] The Court reasoned that, because section 1988 did not require a party to exhaust state administrative remedies prior to filing a section 1983 suit,[66] a "proceeding to enforce" would be interpreted to mean a federal action.[67] Additionally, the Court concluded the request must be denied because none of the work done by counsel in preparation for and during administrative hearings was reasonably expended toward the litigation.[68]

In the instant case, the United States Supreme Court found[69] that

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[63] *Webb*, 471 U.S. at 236-39. Petitioner was represented by counsel at both the administrative hearings and the judicial proceedings. *Id.* The district court awarded attorney's fees to the petitioner but only for services performed in connection with the judicial proceedings. *Id.*

[64] *Id.* at 244. The district court denied fees for services provided at the administrative proceedings before a local school board. *Id.* at 236.

[65] *Id.* at 241. Section 1988 states that in any action or proceeding to enforce § 1983 of the Civil Rights Act, the court may allow attorney's fees. 42 U.S.C. § 1988 (1976).

[66] *Webb*, 471 U.S. at 241. A party bringing a suit to enforce § 1983 could proceed directly to federal proceedings without having to pursue state administrative remedies first. *Id. See* Moor v. County of Alameda, 411 U.S. 693, 701-03 (1973) (section 1988 failed to allow independent actions for attorney's fees and instead allowed remedies in actions to enforce civil rights); Horacek v. Thone, 710 F.2d 496, 499 (8th Cir. 1983)(court distinguished actions coming under Title VII from those under § 1988 based on congressional policy to mandate administrative proceedings under Title VII); Derheim v. Hennepin County Welfare Bd., 688 F.2d 66, 69 (8th Cir. 1982)(state administrative proceedings were not proceedings to enforce under section 1983); Blow v. Lascaris, 668 F.2d 670, 671 (2d Cir. 1982), *cert. denied*, 459 U.S. 914 (1982)(section 1988 on its face referred only to proceeding or actions in court, not state administrative proceedings). *See generally* Parness & Woodruff, *Federal District Court Proceedings to Recover Attorney's Fees For Prevailing Parties on Section 1983 Claims in State Administrative Agencies*, 18 GA. L. REV. 83, 83-106 (1983)(discussion of actions for attorney's fees under § 1988 filed after action has been filed with state administrative agencies).

[67] *Webb*, 471 U.S. at 241. The Court reviewed the legislative history of § 1988 and found that Congress, by inserting the phrase "action or proceeding to enforce § 1983," meant to exclude attorney's fees for work done in state administrative proceedings. *Id.* at 241 n.16. The Court interpreted "action or proceeding" to mean a proceeding in court. *Id.*

[68] *Id.* at 243. The *Webb* Court found the five years of work done in state administrative proceedings were separable from the work done in furtherance of the litigation *Id.* The Court still allowed attorney's fees for some work which was performed before a lawsuit such as the initial pleadings and work done to develop the theory on which to proceed. *Id.*

[69] North Carolina Dep't of Transp. v. Crest St. Community Council, 107 S.Ct. 336, 337 (1986). Justice O'Conner wrote the majority opinion, in which she was joined by Rehnquist, C.J., White, Powell, Stevens, and Scalia, J.J. *Id.*

an administrative complaint to enforce civil rights laws[70] could not be considered the equivalent of a complaint filed in court.[71] Therefore, the *Crest Street* Court held that filing an administrative complaint did not create an action to enforce civil rights laws.[72] The Supreme Court reasoned further that, even if a civil rights action existed because of respondent's claim in an unrelated action,[73] the motion requesting attorney's fees was brought independently,[74] and, as such, no ground to recover attorney's fees had been stated because the fees had not been sought in an action to enforce civil rights laws.[75] In conclusion, the Court held that because respondent's request for attorney's fees was brought separately and for the sole purpose of recovering attorney's fees,[76] the request must be denied.[77]

In dissent,[78] Justice Brennan[79] argued that nothing in the express

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[70] *Id.* at 338. *See supra* note 5.

[71] *Id.* The Court interpreted section 1988 of the Awards Act as meaning that attorney's fees were allowed only when a claim to enforce civil rights laws was filed in court. *Id.* The Court based this interpretation on the literal reading of a portion of § 1988 that provided "in the action or proceeding to enforce the Civil Rights laws listed . . . the *court* may award attorney's fees." *Id.* (emphasis added). The Court also studied the legislative history of the section and found that the history lent support to the proposition of limiting attorney's fees to parties who had filed a civil rights complaint in court. *Id.*

[72] *Id.* The administrative complaint was filed with a federal agency; therefore, no court action existed for the purpose of satisfying the civil rights claim and without such an action a request for attorney's fees could not be considered. *Id.*

[73] *Id.* at 340. Respondents filed a complaint alleging civil rights violations along with a motion to intervene in the ECOS action. *Id.* The Court used language that suggested the ECOS action was not to enforce Title VI because respondents motion was never ruled on and the complaint was dismissed. *Id.*

[74] *Id.* The motion for attorney's fees was brought after respondent's proposed Title VI claims were dismissed. *Id.*

[75] *Id.* The Court rejected respondent's argument that the proposed complaint and motion to intervene comprised a court action and therefore attorney's fees should have been awarded in the ECOS action. *Id.* The Court stated that respondent's motion for attorney's fees was not considered in a court action to enforce civil rights laws under Title VI. *Id.* This denial was based on the premise that in order for attorney's fees to be awarded the request for them must be incorporated in the civil rights action. *Id.*

[76] *Id.* at 341. The *Crest Street* Court noted that respondent's suit to recover attorney's fees was filed solely for that purpose and was in no way part of a civil rights action. *Id.* The administrative proceedings to enforce Title VI were not analogous to a court action, nor was the claim for fees considered in the ECOS action. *Id.*

[77] *Id.* The Court's holding, for a party to recover attorney's fees, requires that the request be filed contemporaneously with, or was part of, a court action to enforce civil rights under Title VI. *Id.*

[78] *Id.* at 342. Justices Marshall and Blackmun joined in the dissent. *Id.*

[79] *Id.* Justice Brennan criticized the majority's holding since it created a need for court action every time a claim covered by § 1988 was filed. *Id.* Justice Brennan reasoned

wording of section 1988 of the Awards Act[80] prohibited an independent action for fees.[81] Brennan emphasized that the congressional purpose behind section 1988 was to provide an avenue for private citizens to vindicate their civil rights and recoup their expenses of doing so,[82] and, accordingly, the broad language of section 1988 authorized recovery of attorney's fees that arose in administrative proceedings.[83] Justice Brennan also contended that limiting recovery of attorney's fees to claims filed in court[84] provided incentive to file unnecessary protective lawsuits which would place a burden on already overloaded federal courts.[85] Furthermore, the dissent argued that reconciliation of the present decision with similar cases in which the Court had awarded attorney's fees was impossible.[86] Justice Brennan concluded that, al-

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that every party who brought an action under § 1988 would file a complaint in court to protect a possible right to attorney's fees. *Id.*

[80] *See supra* note 8.

[81] *Crest Street*, 107 S.Ct. at 343. Justice Brennan argued that the express language of § 1988 required that an action for fees following an administrative hearing was a part of the proceeding to enforce Title VI. *Id.* Justice Brennan claimed that such an action for fees was part of the proceeding whether it was filed before or after the administrative hearing. *Id.* Justice Brennan responded to the majority's argument that the motion must be filed in court by reasoning that literally the court was still the entity which awarded the fees. *Id.*

[82] *Id.* Justice Brennan stressed that Congress enacted the Awards Act to give private citizens a forum in which to enforce their civil rights. *Id.* Justice Brennan argued that an indigent plaintiff who sought vindication of civil rights would be forced to bring action in a federal court where attorney's fees were allowed, because the indigent was not equipped to pay an attorney to work at the administrative level without the possibility of recovering attorney's fees. *Id.*

[83] *Id.* Justice Brennan contended that the words "[i]n any action or proceeding to enforce . . . Title VI . . ." should be construed to allow attorney's fees that arose from administrative proceedings. *Id.* Justice Brennan compared the language of § 1988 to that in Title VII which allowed attorney's fees in administrative proceedings, and found the language almost identical. *Id.* at 344.

[84] *Id.* The dissent noted that the majority's holding precluded a party from recovering attorney's fees unless the complaint alleging civil rights violations was filed in court. *Id.*

[85] *Id.* Justice Brennan expressed concern that a party would file a complaint in court every time a claim arose under § 1988 in an effort to protect the right to attorney's fees if he prevailed. *Id.* at 343. Justice Brennan stated that these protective filings would needlessly burden the courts because if independent actions were allowed, a suit for attorney's fees in federal court would be filed only after a party prevailed at the administrative level. *Id.*

[86] *Id.* Justice Brennan specifically referred to *Carey* where the Court awarded attorney's fees for work done at the administrative level under a Title VII claim. *Id.* Justice Brennan contended that because of almost identical language in the two titles, the case at hand could not be distinguished from *Carey*, where the Court stated that attorney's

though the respondents' request for attorney's fees that arose from administrative proceedings to enforce Title VI was filed independently, the award should be granted based on the language and purpose of section 1988.[87]

The Supreme Court's decision in *Crest Street* severely limits the scope of a prevailing party's right under Title VI to recover attorney's fees under section 1988.[88] The *Crest Street* Court has made it clear that an award of attorney's fees will be denied where the Title VI claim to enforce civil rights is not filed in a court, or where the request for fees is filed independently of the complaint.[89] Plaintiffs have a choice under Title VI of whether to bring a claim in an administrative proceeding or in federal court, but plaintiffs with fewer economic resources will be forced to seek action in federal court so that the possibility of recovering attorney's fees will not automatically and arbitrarily be forfeited.[90] Although the decision to deny attorney's fees to a prevailing plaintiff in an administrative proceeding under Title VI can be justified by a literal reading of the language in section 1988, reconciliation of the *Crest Street* decision with decisions allowing attorney's fees under other civil rights titles is difficult.[91] Whether or not the Supreme Court will justify denying attorney's fees in other types of civil rights actions remains to be seen, as the decision in *Crest Street* is applicable only to Title VI in conjunction with fee awards under section 1988.[92] The decision in *Crest Street* does not seem to be based on settled law and clearly opens the door for courts to deny attorney's fees in civil rights actions based on the Court's strict interpretation of the language of section 1988 without due consideration of the majority of conflicting case law or the legislative purpose behind the statute.[93]

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fees in federal courts were not dependent on whether a claimant prevailed in federal court or in an administrative hearing. *Id.*

[87] *Id.* at 342. Justice Brennan stressed the similarity of the language of § 1988 to that of Title VII that allows attorney's fees in administrative proceedings. *Id.* Justice Brennan also pointed out that the legislative history of section 1988 indicated that an independent action for attorney's fees should be allowed for work done at administrative proceedings to encourage private citizens to vindicate their civil rights. *Id.*

[88] *See supra* note 71 and accompanying text.

[89] *See supra* note 77 and accompanying text.

[90] *See supra* note 82 and accompanying text.

[91] *See supra* notes 83, 86 and accompanying text.

[92] *See supra* note 2 and accompanying text.

[93] *See supra* note 47 and accompanying text.

Constitutional Law—Preemption—ERISA Preempted Mississippi Law of Bad Faith as Applied to Employee Benefit Plan Since Such State Law did not Regulate Insurance

Plaintiff[1] filed a diversity action[2] in the United States District Court for the Southern District of Mississippi[3] against defendant insurance company,[4] to recover general and punitive damages[5] for failure of the defendant to pay benefits under an insurance policy.[6] Plaintiff failed to assert any of the causes of action available under the Employment Retirement Income Security Act (ERISA),[7] and instead based his suit on the Mississippi law of bad faith.[8] Defendant argued that

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[1] Plaintiff was Everate W. Dedeaux, employee of Entex, Inc. (Entex). Pilot Life Ins. Co. v. Dedeaux, 107 S.Ct. 1549, 1551 (1987).

[2] *Id.* The plantiff's complaint, which alleged tort and contract claims under Mississippi law, contained three counts: "tortious breach of contract," "breach of fiduciary duties," and "fraud in the inducement." *Id.*

[3] *Id.*

[4] *Id.* Defendant Pilot Life Insurance Company issued a group insurance policy to Entex, the employer of the plaintiff. *Id.*

[5] *Id.* Plaintiff sought damages for failure to pay benefits, general damages for mental and emotional distress and other incidental damages of $250,000.00 and punitive and exemplary damages of $500,000.00. *Id.*

[6] *Id.* In 1975, Dedeaux injured his back in a work-related accident while employed by Entex in Gulfport, Mississippi. *Id.* Entex had a long term disability employee benefit plan which provided for the collecting and matching of contributions of employees to the plan, and then forwarding these funds to Pilot Life. *Id.* While Entex provided forms for processing disability claims, the defendant bore the responsibility of determining who received disability benefits. *Id.* Following his accident, plaintiff sought permanent disability benefits. *Id.* The defendant terminated the benefits of the plaintiff after two years, then reinstated and terminated these benefits several times in the following years. *Id.*

[7] *Id.* ERISA regulates, among other things, employee welfare benefit plans that make provision for health care or payments in the event of sickness, accident, disability or death. 29 U.S.C. § 1002(1) (1982). One of the essential tools for accomplishing the stated purposes of ERISA is its civil enforcement scheme. *Pilot Life*, 107 S.Ct. at 1555. Under the civil enforcement scheme of ERISA, a plan participant or beneficiary may sue to recover benefits due, to enforce his rights under the plan, or to clarify his rights to future benefits. 29 U.S.C. § 1132(a)(1)(B) (1982). The relief available would be the sum of accrued benefits due, a declaratory judgment concerning entitled benefits, or an injunction against the improper refusal to pay benefits. *Pilot Life*, 107 S.Ct. at 1556. A participant or beneficiary could also seek removal of a fiduciary by suing for breach of fiduciary duty. *Id.*

[8] *Pilot Life*, 107 S.Ct. at 1554. A bad faith cause of action arises when an insurance carrier refuses to pay a claim although there appears to be no arguable basis for refusal

ERISA preempted plaintiff's common law claim of bad faith.[9] At the close of discovery, the federal district court granted the summary judgment motion of the defendant.[10] The United States Court of Appeals for the Fifth Circuit reversed.[11] On writ of certiorari, the United States Supreme Court, *held*, reversed.[12] Where a participant or beneficiary in an employee benefit plan brings suit alleging improper processing of a claim for benefits, and where the suit relies on state common law, ERISA will preempt state law which "relates to" the employee benefit plan and which is not exempted as a law that "regulates insurance." *Pilot Life Insurance Co. v. Dedeaux*, 107 S.Ct. 1549 (1987).

Controversies over the proper relationship between individual and state,[13] and between state and nation,[14] have been at the heart of polit-

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or when a breach of an insurance contract is accompanied by an intentional wrong or gross negligence of sufficient import to become an independent tort. *Id.* The Mississippi Supreme Court recognized such a cause of action, compensable by punitive damages. *Id.* (citing Blue Cross & Blue Shield of Mississippi, Inc. v. Campbell, 466 So. 2d 833, 842 (1984)).

[9] *Pilot Life*, 107 S.Ct. at 1551. Defendant argued that the three preemption sections within ERISA superceded the state common law claims of the plaintiff. *Id.* The preemption clause of ERISA provided that if a state law related to any employee benefit plans, the law would be superceded by ERISA. 29 U.S.C. § 1144(a) (1982). The savings clause excepted from the preemption clause those laws that "regulate insurance." 29 U.S.C. § 1144(b)(2)(A) (1982). The third provision was the deemer clause which stated that a state law "purporting to regulate insurance" could not deem an employee benefit plan to be an insurance company. 29 U.S.C. § 1144(b)(2)(B) (1982).

[10] *Pilot Life*, 107 S.Ct. at 1551. The district court entered a summary judgement for the insurance company on the grounds of ERISA preemption and the plaintiff appealed. *Id.*

[11] *Id.* The Court of Appeals for the Fifth Circuit based its reversal primarily on Metropolitan Life Insurance Co. v. Massachusettes, 471 U.S. 724 (1985). *Pilot Life*, 107 S.Ct. at 1551. In *Metropolitan Life*, the Court realized its decision allowed insured plans to be indirectly regulated, yet prohibited regulation of uninsured plans. Dedeaux v. Pilot Life Ins. Co., 770 F.2d 1311, 1315 (5th Cir. 1985). However, the court reasoned that congressional intent to save state insurance regulation was the cause. *Id.* at 1316. Reading the savings clause broadly and the preemption and deemer clauses narrowly, as did the Court in *Metropolitan Life*, the Fifth Circuit concluded that laws affecting the relationship between the insurer and the insured were the core of the "business of insurance." *Id.* The Fifth Circuit expressed the view that the Mississippi law of bad faith was a law regulating insurance and was thereby "saved" from preemption. *Id.* at 1316-17.

[12] *Pilot Life*, 107 S.Ct. at 1551.

[13] In English law, preemption was the right of the Crown to purchase its necessaries before all others. 1 JONES' BLACKSTONE COMMENTARIES 287 (1915). The term "preemption" in the United States originally referred to the rights of settlers to purchase government land at a fixed price in preference to all others. Nix v. Allen, 112 U.S. 129, 131 (1884).

[14] Alexander Hamilton considered the notion of preemption to be axiomatic to the

ical contention throughout the course of history.[15] The doctrine of preemption,[16] invoked under the supremacy clause[17] and other articles and amendments of the Constitution,[18] has been utilized to define

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concept of a federal system. A. HAMILTON, THE FEDERALIST No. 33, 204-05 (Mentor Book ed. 1961). However, James Madison noted the task of "marking the proper line of partition" between the federal and state governments as one of the most difficult problems faced by the authors of the Constitution. J. MADISON, THE FEDERALIST No. 37, 26-227 (Mentor Book ed. 1961).

[15] Hutchinson & Ifshin, *Federal Preemption of State Law Under the Employee Retirement Income Security Act of 1974*, 46 U. CHI. L. REV. 23, 23 (1978-79).

[16] Freeman, *Dynamic Federalism and the Concept of Preemption*, 21 DE PAUL L. REV. 630, 630 (1972). Preemption currently may be defined as the legal effect of the legislative ability of the federal government to exclude a state from an area of law, or the constitutional bar upon a state to intrude upon certain areas of legislation. *Id.* at 630 n.1. The preemption doctrine also has been called one of the primary judiciary vehicles for shaping federalism, having been used extensively since the federal regulatory advances of the New Deal to "mediate the frictions" that have accompanied extension of federal regulation into provinces of traditional state concerns. Note, *The Pre-emption Doctrine: Shifting Perspectives on Federalism and the Burger Court*, 75 COLUM. L. REV. 623, 624 (1975).

[17] U.S. CONST. art. VI, § 2. The supremacy clause states:

> This Constitution, and the Laws of the United States which shall be made in Pursuance thereof; and all Treaties made, or which shall be made, under Authority of the United States, shall be the supreme Law of the Land; and Judges in every State shall be bound thereby, any Thing in the Constitution or Laws of any State to the Contrary notwithstanding.

Id.

While case law and literature indicated that the doctrine of preemption "hinged" on the supremacy clause, an alternative view was that the necessary and proper clause, U.S. CONST., art. I, § 8, imposed upon the Supreme Court a duty to distribute power within the federal system, independent of congressional objectives. *Compare* Perez v. Campbell, 402 U.S. 637, 649 (1970)(state statute protecting judgment creditors from debtors discharged in bankruptcy invalid under supremacy clause) *and* Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 236 (1947)(state law must give way by virtue of supremacy clause) *and* Hines v. Davidowitz, 312 U.S. 52, 63 (1941)(supremacy of national power in field of foreign affairs made clear by Constitution) *and* Note, *Preemption as a Preferential Ground: A New Canon of Construction*, 12 STAN. L. REV. 208, 210 (1959)(supremacy clause as basis for preemption of state laws) *with* Freeman, *supra* note 16, at 638-39 (aggressive mode of assessing preemptive capacity of federal law came to impair genuine balancing of state and federal interests).

[18] Freeman, *supra* note 16, at 632. U.S. CONST. art. I, § 10 specifically prohibited a state to enter into any treaty, coin money, or pass certain laws regarding contracts, commerce or foreign policy. *Id.* The thirteenth amendment prohibited a state from establishing involuntary servitude except as a punishment. U.S. CONST., amend. XIII. The fourteenth amendment restricted state action abridging privileges and immunities of citizens or depriving them of life, liberty or property without due process of law. U.S. CONST., amend. XIV. § 1. The fifteenth amendment forbade states from denying rights because of race, color or previous condition of servitude. U.S. CONST., amend. XV.

spheres of governmental authority within the federal system.[19] Any degree of internal consistency among preemption cases as a whole has been prevented by different doctrinal approaches, such as occupation of the field[20] and conflict grounds.[21] Furthermore, this doctrinal inconsistency has simply mirrored the vacillating perspective of the Court towards the concept of federalism.[22]

Congress proclaimed the exclusiveness of its power at an early stage in the case of *Gibbons v. Ogden*.[23] Deciding that the New York statutes[24] granting a monopoly to operate steamboats in New York wa-

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[19] *See* Note, *supra* note 16, at 624. Certain areas were dominated by federal activity. *See, e.g.*, Pacific Gas & Elec. v. State Energy Resources Conservation Comm'n, 461 U.S. 190, 195 (1983)(Atomic Energy Act preempted state law concerning nuclear energy); Perez v. Campbell, 402 U.S. 637, 649 (1970)(federal Bankruptcy Act overrode Arizona law withholding driving privilege from auto accident judgment debtors); Sears, Roebuck & Co. v. Stiffel Co., 376 U.S. 225, 231-32 (1964)(federal patent and copyright laws preempted state laws); Hines v. Davidowitz, 312 U.S. 52, 62 (1941)(federal government prevailed in field of foreign affairs).

[20] Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947). In order to find congressional occupation of a field of law, the Court required a showing of a clear and manifest purpose that the area be exclusively federal. Florida Lime & Avocado Growers, Inc. v. Paul, 373 U.S. 132, 146 (1963). However, the Supreme Court has used factors other than expressions of congressional purpose to establish preemptive intent. *Rice*, 331 U.S. at 230. The factors included whether the federal regulatory scheme was so pervasive that no room to act was left for the states, whether congressional legislation touched a field in which federal interest was so dominant and whether the object to be obtained and the character of the obligations imposed by it revealed the same purpose. *Id.* Often, the regulated subject matter required national uniformity and federal primacy. *Florida Lime*, 373 U.S. at 142. *See also* Head v. New Mexico Bd. of Examiners, 374 U.S. 424, 430 (1963)(Court characterized subject matter as local, then determined whether Congress occupied the field).

[21] Perez v. Campbell, 402 U.S. 637, 644 (1970). The Court interpreted federal and state statutes at issue in order to determine if a true conflict existed. *Id.* The Court used interchangeably the words "conflict," "interference," "repugnance," "irreconcilability," and "inconsistency." Hirsch, *Toward a New View of Federal Preemption*, 1972 U. ILL. L. REV., 515, 525. The most difficult conflict question occurred when federal and state subject matter differed but still conflicted at one common point. *See, e.g., Perez*, 402 U.S. at 644 (recognizing conflict between federal bankruptcy laws and state regulation of negligent automobile judgment debtors); Huron Portland Cement Co. v. City of Detroit, 362 U.S. 440, 445 (1960)(federal maritime safety regulations and municipal pollution regulation). *Cf.* Note, *supra* note 16, at 626 (Court distinguished between occupation of field and conflict, yet absolute distinction could not be inferred).

[22] Note, *supra* note 16, at 626.

[23] 22 U.S. (9 Wheat) 1 (1824). Daniel Webster, counsel for appellant, made the argument that once the federal government regulated a given subject, any state law which purported to govern the same area was invalid, even if the state law only duplicated or merely went further than the federal law. *Id.* at 3-33.

[24] *Id.* at 4-5. On March 19, 1787, the New York Legislature gave the sole and exclu-

ters were repugnant to the commerce clause,[25] the United States Supreme Court held that any act inconsistent with the Constitution was invalid.[26] This federally-directed view of preemption has not been continuous, however.[27] Particularly in the last fifty years, shifting presumptions with regard to preemption of state law have caused considerable confusion and criticism.[28] The tension between the supremacy of

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sive right to John Fitch to operate any kind of steamboat on New York waterways for 14 years. *Id.* at 5. The Legislature repealed this grant on March 27, 1798, conferring the privilege on Robert R. Livingston for 20 years. *Id.* at 5-6. On April 5, 1803, New York extended to Robert Fulton and Livingston the same privilege for 20 years. *Id.* at 6. The Legislature gave a monopoly to the aforementioned on April 11, 1808, for five years for every additional boat, not to exceed 30 years. On April 9, 1811, New York provided that Livingston and Fulton would have a cause of action against anyone navigating New York waters in violation of the acts. *Id.*

[25] U.S. CONST. art. I, § 8, cl. 3.

[26] *Gibbons*. 22 U.S. (9 Wheat) at 240.

[27] *See, e.g.*, Florida Lime & Avocado Growers, Inc., v. Paul, 373 U.S. 132, 142 (1963)(showed trend toward increased tolerance of state legislation supplementing federal action). *See also* Hutchinson & Ifshin, *supra* note 15, at 36 (federal preemption interpreted broadly in past, showing trend toward moderate approach).

[28] Note, *A Framework for Preemption Analysis*, 88 YALE L.J. 363, 363 (1978); *see* Note, *supra* note 16, at 625 (decisions on preemption had ad hoc quality). During the 1930's, the Supreme Court tempered its undifferentiated hostility to state regulation of matters already regulated by the federal government. Mintz v. Baldwin, 289 U.S. 346, 350 (1933). Absent an actual conflict, preemption occurred only when federal intent to occupy the field was "definitely and clearly" shown. *Id. See also*, L. TRIBE, AMERICAN CONSTITUTIONAL LAW 379 n.12 (1978)(court sanctioned state regulation that supplemented federal efforts as long as purpose of federal enactment not significantly impeded by state law). Decisions during this period generally concerned commerce clause statutes and state exercise of its police powers. *See* Maurer v. Hamilton, 309 U.S. 598, 614 (1940)(state highway act consistent with commerce clause where public health and safety concerned); H.P. Welch Co. v. New Hampshire, 306 U.S. 79, 82 (1939)(state motor vehicle statute not repugnant to Constitution); *Mintz*, 289 U.S. at 350 (same).

A federally-directed formulation of preemption emerged in the 1940's with Hines v. Davidowitz, 312 U.S. 52, 62 (1941); *see also* Catz & Lenard, *The Demise of the Implied Federal Preemption Doctrine*, 4 HASTINGS CONST. L.Q., 295, 307 (1977)(doctrinal evolution after *Hines* created a presumption of federal preemption). The Supreme Court for the first time considered that federal preemption may have derived from a source other than the commerce power. Catz and Lenard, *supra*, at 307. In *Hines*, a Pennsylvania act with similar alien registration to the federal act, but with more extensive criminal sanctions, was preempted based on a foreign affairs power-based presumption. *Hines*, 312 U.S. at 66-67. The Court sought to determine whether a state statute stood as an obstacle to the "purposes and objectives of Congress." *Id.* at 67. Thus, by the nature of the federal regulation, rather than clear congressional intent to occupy the field or actual conflict, the Court found that preemption applied. *Id.* at 70. Similarly, in Rice v. Santa Fe Elevator Corp., 331 U.S. 218, 230 (1947), although the Court found specific congressional intent, other indicative factors mentioned confirmed the demise of state-directed preemption doctrine. Freeman, *supra* note 16, at 633, n.61. *But see*, Kesler v. Dep't of

federal and state legislation has only been intensified with the passage of ERISA[29] and the subsequent extensive litigation concerning its interpretation.[30]

Public Safety, 369 U.S. 153, 172 (1962)(state statute suspending motor vehicle negligent defendant driver's license at behest of judgment debtor ruled exercise of state police power)(overruled by Perez v. Campbell, 402 U.S. 637, 649 (1970)); Huron Portland Cement Co. v. City of Detroit, 362 U.S. 440, 446 (1960)(Court refused to find conflict between municipal smoke abatement ordinance and federal ship licensing requirements).

Additional preemptive bases were born during this judicially activist period. *See, e.g.*, Farmers Educ. & Coop. Union of Am. v. WDAY, 360 U.S. 525, 531-35 (1959)(considerations of fairness to broadcasters persuaded Court to preempt state law); San Diego Bldg. Trades Council v. Garmon, 359 U.S. 236, 245 (1959)(policy rationale utilized to leave to National Labor Relations Board adjudicative development of labor relations law); Pennsylvania v. Nelson, 350 U.S. 497, 509 (1956)(state law preempted where potential conflict existed).

In 1973, the Court abruptly began to change direction. *See* Note, *supra* note 16, at 639. The Court handed down decisions narrowly construing the preemptive capability of constitutional grounds, permitting extensive concurrent jurisdiction and interpreting the silence of Congress in favor of the states. *See, e.g.*, Goldstein v. California, 412 U.S. 546, 548 (1973)(narrowly construed preemptive scope of copyright clause); State Dep't of Social Serv. v. Dublino, 413 U.S. 405, 413 (1973)(intention of Congress to act in field as exercise of federal supremacy was not lightly presumed); Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware, 414 U.S. 117, 127-140 (1973)(strong interest in California to protect wage earners prevailed over New York Stock Exchange Rule enacted pursuant to Securities Exchange Act). *But see* Burbank v. Lockheed Air Terminal, 411 U.S. 624, 633-38 (1973)(federal aviation regulation preempted municipal curfew on late evening flights). In summary, as adherence to a consistent principle has constituted an impossibility in the preemption area, the most realistic approach has been to recognize the impossibility of consistency and adopt a case by case approach. *See* Note, *supra* note 16, at 654.

[29] Brief of Amicus Curiae ERISA Industry Committee at 32, Dawson v. Whaland, *aff'd sub nom.* Wadsworth v. Whaland, 562 F.2d 70 (1st Cir. 1977), *cert denied*, 435 U.S. 980 (1978). Congressional studies in the early 1970's revealed corporate mismanagement and abuse in the instituting and handling of pension benefit programs, resulting in devastating losses to middle aged and elderly working men and women. Note, *ERISA: Preemption of State Health Care Laws and Worker Well Being*, 1981 U. ILL. L. REV. 825, 830 and n.35. ERISA was the first comprehensive body of federal law "impinging upon all vital aspects" of employee pension and benefit plans. Manno, *ERISA Preemption and the McCarran-Ferguson Act: The Need for Congressional Action*, 52 TEMP. L.Q. 51, 51 (1979). Prior to ERISA, at the federal level, the Internal Revenue Code and Section 302 of the Taft-Hartley Act regulated pensions funds. Sherrick, *ERISA Preemption: An Introduction*, 64 MICH. B. J., 1074, 1074 (1985). In 1958, Congress enacted the Welfare and Pension Plan Disclosure Act (WPPDA), recognizing and preserving state authority to regulate pension plans and requiring only that administrators meet certain reporting and disclosure requirements. *Id.*

[30] *See, e.g.*, Metropolitan Life Ins. Co. v. Massachusettes, 471 U.S. 724, 724 (1985)(mandated-benefits law regulated business of insurance); Shaw v. Delta Air Lines, 463 U.S. 85, 86 (1983)(state laws relating to employee benefits plan preempted); Alessi v.

The seminal case addressing controversial language within ERISA was *SEC v. National Securities, Inc.*[31] The issue in *National Securities* was whether an Arizona statute[32] had been enacted to regulate the business of insurance[33] within the meaning of the McCarran-Ferguson Act.[34] Although the Court found that regulation of the relationship between the stockholder and security company was security regulation rather than insurance regulation,[35] it nevertheless illuminated the

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Raybestos-Manhattan, Inc., 451 U.S. 504, 505 (1981)(state law directly conflicting with ERISA preempted). Congress did not foresee the potentiality of conflict with traditional regulation of insurance benefits. *Alessi*, 451 U.S. at 505. There was no indication of recognition in the record that conditions and terms of pension plans were often terms and conditions of group insurance policies issued to the plans and that a literal reading of the savings clause (29 U.S.C. § 1144(b)(2)(A)), was inconsistent with the plain wording of the preemption clause (29 U.S.C. § 1144(a)), and legislative history. *Alessi*, 451 U.S. at 505.

[31] 393 U.S. 453 (1969). The Securities and Exchange Commission (SEC) had sought to prevent a merger between Producers Life Insurance Company and National Life and Casualty Insurance Company on the grounds of violation of Rule 10b-5 of the Securities Exchange Act of 1934. *Id.* at 566.

[32] ARIZ. REV. STAT. ANN. § 20-731 (Supp. 1969). The Act concerned merger or consolidation of stock insurers providing for filing with and approval by the director of insurance. *Id.* Following a public hearing, a director would give his approval unless he found the plan: (1) contrary to law; or (2) inequitable to the stockholders of any domestic insurer involved. *Id.*

[33] *National Securities*, 393 U.S. at 567. The appellees contended that the Arizona act barred the suit since the Arizona Director of Insurance found the merger was not inequitable to the domestic stockholders or contrary to law. *Id.* The SEC argued that the state statute, aimed at protecting the interests of those who owned stock in insurance companies, was not a state attempt to regulate the "business of insurance." *Id.* Therefore, the statute would not be saved by the McCarran-Ferguson Act. *Id.*

[34] *Id. See* 15 U.S.C. §§ 1011-1015 (1982). The McCarran-Ferguson Act was a response to United States v. South Eastern Underwriters, 322 U.S. 533, 562 (1944), holding that insurance transactions could be federally regulated under the commerce clause. *National Securities*, 393 U.S. at 567. The purpose of the Act was to assure a continuance of state regulation and taxation of the "business of insurance." *Id.* at 568. The applicable section provided "[n]o Act of Congress shall be construed to invalidate, impair, or supercede any law enacted by any State for the purpose of regulating the business of insurance . . . unless such Act specifically relates to the business of insurance." 15 U.S.C. § 1012(b) (1982). Although little in the legislative history shed light on the meaning of "business of insurance," in context it was clear that Congress was concerned with the continued supremacy of the states in that area of the law and intended by the enactment to assure that policyholders remained subject to state regulation. *National Securities*, 393 U.S. at 568.

[35] *National Securities*, 393 U.S. at 569-70. The concern of the SEC was that the insurance companies had made fraudulent misrepresentations to stockholders. *Id.* The appellees argued that interference with the merger would supercede state insurance laws. *Id.* The Court found no conflict between the interests of the SEC and the state of Arizona. *Id.* The state concern was stockholder protection, rather than security of interests

meaning of the controversial phrase "business of insurance."[36] Laws regulating the "business of insurance" concentrated on state regulation involving the contract of insurance, the relationship between the insurer and the insured, policies which were issued and their "reliability, interpretation and enforcement."[37] The Court emphasized that the clear focus of Congress in enacting laws regulating the "business of insurance" was to protect and regulate the relationship between insurer and insured, directly or indirectly.[38]

The Supreme Court spoke initially with regard to a substantive aspect of ERISA in *Alessi v. Raybestos-Manhattan, Inc.*[39] Reiterating that the preemption of state law was not favored absent persuasive reasoning,[40] the Court held that the New Jersey statute[41] in question, which prohibited offsetting workers' compensation payments against pension benefits, was preempted by section 1144(a) of ERISA,[42] since it eliminated integration as a method for calculating pension benefits.[43] In doing so, the *Alessi* Court pointed out the explicit congressional au-

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of policyholders. *Id.*

[36] *Id.* at 568-69. The Court explained that the "business of insurance" included the setting of rates, selling and advertising of policies, and licensing of companies and agents. *Id.* at 568.

[37] *Id.* at 568. Many activities of insurance companies were subject to paramount federal regulation. *Id.* The statute applied only when companies engaged in the "business of insurance." *Id.*

[38] *Id.* at 568-69. The intention of Congress was not to give the states any power to regulate beyond that which they held prior to *Southeastern Underwriters. Id.* at 568.

[39] 451 U.S. 504 (1981). The Court noted the probable jurisdiction of the employees of Raybestos-Manhattan, Inc. and granted certiorari to the petition of the employees of General Motors. Alessi v. Raybestos-Manhattan, Inc., 449 U.S. 949 (1980); Buczynski v. General Motors Corp., 449 U.S. 950 (1980). The Court joined both suits, initiated in New Jersey state court as Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504 (1981). *Id.*

[40] *Alessi*, 451 U.S. at 522, (citing Chicago & North Western Transp. Co. v. Kato Brick & Tile Co., 450 U.S. 311, 317 (1981)).

[41] N.J. STAT. ANN. § 34:15-29 (West Supp. 1980-1981)(as amended by 1977 N.J. LAWS, ch. 156). The amendment to the Worker's Compensation Act stated that "the right of compensation granted by this chapter . . . shall not be set off against employee's retirement pension benefits or payments." *Id.*

[42] *Alessi*, 451 U.S. at 510. The *Alessi* Court noted that ERISA's § 1144(a), the preemption section, was enacted after careful study and was a "comprehensive and reticulated" statute. *Id. See* Nachman Corp. v. Pension Benefit Guar. Corp., 446 U.S. 359, 361-62 (1980)(ERISA as comprehensive statute designed to promote interests of employees and beneficiaries in employee benefit plans).

[43] *Alessi*, 451 U.S. at 524. Integration was a calculation practice by which insurers determined benefit levels by combining pension funds with other income sources available to retired employees. *Id.* at 514.

thority for the preemptive effect of the section,[44] and concluded that the language "relate to pension plans"[45] indicated a broad preemptive intent.[46] While stressing the exclusive federal nature of pension plan regulation,[47] the Court also found an additional ground for preempting the state law[48] in the direct conflict between a state statute and the federal policy to keep pension benefits subject to either collective bargaining or federal legislation.[49]

Searching for avenues of relief from federal preemption, appellants in *Union Labor Life Insurance Co. v. Pireno*[50] argued that a peer review committee established to evaluate chiropractic claims in New

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[44] *Id.* at 522. ERISA permitted integration of pension funds with other public income maintenance monies. *Id.* at 524. New Jersey's amendment applied directly to this calculation technique. *Id.*

[45] *Id.* at 525. Although the New Jersey law directly affected pension regulation, the Supreme Court found that even indirect state action intruded on the area of exclusive federal control which it purported to regulate through ERISA. *Id.*

[46] *Id.* at 524. The legislative history of the preemption question revealed that initially both the House and Senate passed bills which would have limited ERISA's preemptive effect specifically to subjects covered within the Act. Sherrick, *supra* note 29, at 1074. The Conference Committee rejected this limited form in favor of the current version. *Id.* Even though Senator Jacob Javits clearly stated that such broad preemption language might create "regulatory lacunae" or lead to other unforeseen problems, the conferees chose not to limit the scope but to entrust a "watchdog body" to recommend new legislation as was necessary. Hutchinson & Ifshin, *supra* note 15, at 41. Many federal district courts have followed the broad preemptive interpretation. *See* Standard Oil Co. of California v. Agsalud, 442 F.Supp. 695, 705-07 (N.D.Cal. 1977)(ERISA preempted Hawaii Prepaid Health Care Act requiring employees to be covered by comprehensive health care benefits), *aff'd*, 633 F.2d 760 (9th Cir. 1980), *aff'd mem.*, 454 U.S. 801 (1981); Hewlett-Packard Co. v. Barnes, 425 F.Supp. 1294, 1297-1300 (N.D.Cal. 1977)(ERISA preempted California Knox-Keene Act as it affected self-insuring health care plans not sheltered under savings clause), *aff'd*, 571 F.2d 502 (9th Cir. 1978). *But see* Gast v. State, 36 Or. App. 441, 458-59, 585 P.2d 12, 20-23 (1978)(ERISA did not preempt Oregon statute prohibiting sex discrimination in allocation of fringe benefits).

[47] *Alessi*, 451 U.S. at 523. The Court noted that the preemption clause demonstrated that Congress intended to depart from previous legislation, allowing state regulation over pension funds, and to establish a federally regulated system. *Id.* (citing Malone v. White Motor Corp., 435 U.S. 497, 512, 514 (1978)).

[48] *Alessi*, 451 U.S. at 526. The term "state," defined under ERISA, included any political subdivision, agency or instrumentality thereof which endeavored to regulate *directly* or *indirectly* the terms of employee benefit plans. *Id.* (emphasis added). *See also* Wadsworth v. Whaland, 562 F.2d 70, 77 (1st Cir. 1977)(indirect state action could "relate to" employee benefit plan), *cert. denied*, 435 U.S. 980 (1978).

[49] *Alessi*, 451 U.S. at 525-26. In bolstering its finding of preemption on an additional ground, *Alessi* indicated that a "direct clash" might be necessary to a finding of preemption. Kilberg & Inman, *Preemption of State Laws Relating to Employee Benefit Plans: An Analysis of Section 514*, 62 TEX. L. REV. 1313, 1323 (1984).

[50] 458 U.S. 119 (1982).

York fell within the coverage of the McCarran-Ferguson Act.[51] The Court, recognizing that the language of the Act referred to laws regulating the "business of insurance," rather than the business of insurance companies, concluded that use of the peer review committee did not come within the meaning of the Act.[52] The breadth of the preemption clause, tentatively settled in *Alessi*, was defined emphatically in *Shaw v. Delta Air Lines*.[53] Involving New York fair employment laws,[54] *Shaw* concerned two issues, interpretation of the phrase "relate to" in section 1144(a)[55] and exceptions to section 1144(a) applicable to save the state fair employment laws from preemption.[56] The *Shaw*

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[51] *Id.* at 122-24. New York law required health insurance policies to cover chiropractic claims. *Id.* at 122. However, Union Labor Life Insurance Co. (ULL) policies limited its liability to reasonable charges. *Id.* Consequently, ULL formed a peer review committee to evaluate the cost and necessity of claims. *Id.* at 123. Pireno brought suit alleging that the peer review committee violated the Sherman Act as a conspiracy to fix prices. *Id.* at 124. ULL argued that the McCarran-Ferguson Act exempted its use of the committee from anti-trust scrutiny, as the practice constituted the "business of insurance." *Id.*

[52] *Id.* at 126-133. The Court held that Group Life & Health Insurance Co. v. Royal Drug Co., 440 U.S. 205 (1979) controlled the decision. *Pireno*, 458 U.S. at 126. Analyzing the three criteria presented therein, whether the practice transferred or spread the risk of the policyholder, was an integral part of the relationship between the insurer and the insured, and limited its concern to entities within the insurance industry, the Court found that the peer review committee met none. *Id.* at 129-33. In dissent, Justice Rehnquist, joined by Chief Justice Burger and Justice O'Connor, premised that the peer review committee constituted a claims adjuster. *Id.* at 134-40. The majority disagreed, finding the committee merely ancillary to the claims adjustment process, as it involved parties entirely outside the insurance process. *Id.* at 134 n.8.

[53] 463 U.S. 85 (1983). The Court recognized that the *Alessi* decision relied on the state law's frustration of congressional intent, rather than express statutory language or legislative history. *Id.* at 96-97 n.15. Therefore, its holding was instructive while not dispositive. *Id.* Referring to BLACK'S LAW DICTIONARY, the Court reaffirmed the plain meaning of "relate to" as having connection with or reference to something. *Id.* at 97 n.16.

[54] *Shaw*, 463 U.S. at 88-89. The state laws at issue were the Human Rights Law, N.Y. EXEC. LAW §§ 290-301 (McKinney 1982 & Supp. 1982-83), prohibiting sex-discriminatory employment practices, and the Disability Benefits Law, N.Y. WORK COMP LAW §§ 200-242 (McKinney 1965 & Supp. 1982-83), requiring employers to pay specified disability benefits for non-occupational illness or injury. *Shaw*, 463 U.S. at 88-89.

[55] *Id.* at 97-100. The Court reviewed the legislative history in addition to the structure of the statute. *Id.*

[56] *Id.* at 100-107. One exception argued was that the Human Rights Law was exempt from preemption under § 1144(d), providing that § 1144(a), the preemption clause, shall not "be construed to alter, amend, modify, invalidate, impair, or supercede any law of the United States." *Id.* at 100-01 (construing 29 U.S.C. § 1144(d) (1982)). Additionally, appellants argued that preemption of the Human Rights Law would impair and modify Title VII of the Civil Rights Act of 1964, changing the means by which it was enforced. *Shaw*, 463 U.S. at 101. A further exception argued was that § 1003(b)(3) exempted from

Court recognized the broad sweep[57] of the preemption clause in holding that both of the New York statutes "related to" employee benefit plans.[58] Endeavouring to utilize section 1144(d) to exempt the Human Rights Law, the Court rejected the double savings clause argument as simplistic.[59] However, the Court concluded that state fair employment laws played a significant role in enforcing Title VII,[60] and that preemption would impair and frustrate federal law.[61] Therefore, the Court ruled that ERISA only partially preempted such law.[62] With regard to

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ERISA coverage employee benefit *plans* "maintained *solely* for the purpose of complying with applicable workmen's compensation laws or unemployment compensation or disability insurance laws." *Id.* at 92 (emphasis added).

[57] *Shaw*, 463 U.S. at 100. Courts and commentators have criticized the broad sweep interpretation of § 1144(a) as leaving a "gap" with many aspects of welfare benefit plans unregulated, because ERISA itself does not regulate them. Note, *ERISA: Supreme Court Clarifies Preemptive Effect of Section 514(a) on State Welfare Regulation: Shaw v. Delta Airlines, Inc.*, 18 SUFFOLK U.L. REV. 723, 750 (1984). *See, e.g.*, Howard v. Parisian, Inc., 807 F.2d 1560, 1565 (11th Cir. 1987)(prohibition of state law claim left gap with no liability under ERISA or state law); Phillips v. Amoco Oil Co., 799 F.2d 1464, 1470 (11th Cir. 1986)(holding that preemption of fraud claim by ERISA did not remedy wrong employees suffered, therefore, leaving "gap" in law), *cert. denied*, 107 S. Ct. 1893 (1987). In response to the gap dilemma, the Eleventh Circuit replied that such a gap was legitimate if it was the intended result of Congress. *Phillips*, 799 F.2d at 1470.

[58] *Shaw*, 463 U.S. at 100. The Human Rights Act placed a prohibition on benefit plans and the Disability Law required specific plan payments. *Id.* at 88-89. *Shaw* has been used as precedent for preemption of state law claims. *See, e.g.*, Gilbert v. Burlington Indus., Inc., 765 F.2d 320, 326-28 (2nd Cir. 1985), *aff'd*, 106 S.Ct. 3265 (1986)(state law claim to obtain severance pay provided by benefit plan preempted); Ellenburg v. Brockway, Inc., 763 F.2d 1091, 1095 (9th Cir. 1985)(state law claims to recover wrongfully withheld retirement benefits preempted); Scott v. Gulf Oil Corp., 754 F.2d 1499, 1505 (9th Cir. 1985)(state law claims arising out of administration of benefits preempted). *But see* Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan Enters., Inc., 793 F.2d 1456, 1465-70 (5th Cir. 1986)(ERISA did not preempt state law breach of fiduciary duty claims); Lane v. Goren, 743 F.2d 1337, 1339-41 (9th Cir. 1984)(state anti-discrimination laws applying to employee benefit plan not preempted); Am. Telephone & Telegraph Co. v. Merry, 592 F.2d 118, 121 (2nd Cir. 1979)(some state actions affected employee plans too tenuously to "relate to").

[59] *Shaw*, 463 U.S. at 101 n.22. The double savings clause argument was that because ERISA did not preempt Title VII, and Title VII did not preempt state fair employment laws, then ERISA did not preempt such laws. *Id.*

[60] *Id.* at 102.

[61] *Id.* Because preemption would bar state agencies from granting relief, the Equal Employment Opportunity Commission (EEOC) could not refer plans to the state. *Id.* The only remedy available would be federal. *Id.* Claims settled at the state level would be handled at the EEOC, thus increasing its burden. *Id.*

[62] *Id.* at 103. Where the state law prohibited employment practices that were lawful under Title VII, the state law was preempted. *Id.* at 103-06. The Court acknowledged that partial preemption created practical problems but expressed caution with regard to

the effect of section 1003(b)(3) on the Disability Law, the Supreme Court, distinguishing between plans and portions of plans, held that states might require separately administered disability plans which would be exempt from ERISA.[63] However, portions of multi-benefit plans, not maintained solely to comply with the Disability Benefits Law, would not be exempt.[64] On this basis, the Court declared that ERISA did not preempt the New York disability statute.[65]

Resolving the interpretation of the preemption clause had a negligible effect on the flow of litigation, as two years later the Supreme Court addressed the complex savings[66] and deemer clauses of ERISA in *Metropolitan Life Insurance Co. v. Massachusetts*.[67] At issue was whether a Massachusetts mandated-benefits law[68] regulated insur-

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transforming § 1144(d) into a general savings clause. *Id.* at 105-06.

[63] *Shaw*, 463 U.S. at 106-08. The Court discounted motive as the appropriate test for § 1003(b)(3) exemptions, reasoning any employer could maintain he offered disability benefits for altruistic purposes. *Id.* at 107. Appellees could not avoid compliance with the Disability Benefits Law by adopting plans with inferior disability provisions, however, since the state had the option of requiring separately administered plans. *Id.* at 108. In reality, this ruling allowed states such leverage over employers as to induce them to voluntarily alter their ERISA plans. *See* Note, *supra* note 57, at 752.

[64] *Shaw*, 463 U.S. at 107. The Court felt that when Congress referred to "plan," it did not refer to individual benefits offered by an employee benefit plan. *Id.* The *Shaw* Court pointed out that by use of the word "solely" Congress demonstrated the purpose of the entire plan must be to comply with the disability insurance law. *Id.* The Court noted that plans which provided which benefits, in addition to serving employee needs more broadly as a result of collective bargaining, were not exempt. *Id.* (citing Alessi v. Raybestos-Manhattan, Inc., 451 U.S. 504, 523 n.20 (1981)).

[65] *Shaw*, 463 U.S. at 109. A state could not require an employer to alter its ERISA plan, but it could compel an employer to provide a separately administered plan if the ERISA plan did not satisfy state requirements. *Id.* at 108.

[66] Metropolitan Life Ins. Co. v. Massachusettes, 471 U.S. 724, 739-47 (1985). The Court, criticizing the preemption sections as improper models of legislative drafting, pointed out that while the preemption clause broadly preempted state law, the savings clause broadly retained state power over almost the same regulation. *Id.* at 739. Commentators, concerned with this seeming contradiction, have urged Congress to clarify the legislation. *See* Manno, *supra*, note 29 at 76. Legislation to amend ERISA, presented in 1979, intending to overrule Wadsworth v. Whaland, 562 F.2d 70 (1st Cir. 1977), *cert. denied*, 435 U.S. 980 (1978) died without being debated. *Metropolitan Life*, 471 U.S. at 740 n.16.

[67] *Metropolitan Life*, 471 U.S. at 740. The Court reasoned that if Congress had not intended to preserve laws regulating insurance contracts by the savings clause, it would not have explicitly exempted such laws in the deemer clause, when they were directly applicable to benefit plans. *Id.* at 741.

[68] MASS. GEN. LAWS ANN., ch. 175, § 47B (West Supp. 1985). Mandated-benefit laws regulated substantive content of health insurance laws to improve state health policy. *Metropolitan Life*, 471 U.S. at 729-31. The law at issue, § 47B, addressed mental illness

ance.[69] Appellants argued that the statute was related to employee benefit plans,[70] and did not fall within the savings clause as it was not a traditional insurance law.[71] The Supreme Court interpreted the savings clause broadly[72] and reasoned that the deemer clause explicitly indicated the intention of Congress to include insurance laws within the scope of the savings clause.[73] Additional support for this decision came from prior Supreme Court holdings construing the term "business of insurance" under the McCarran-Ferguson Act.[74] The *Metropol-*

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coverage. *Id.*

[69] *Metropolitan Life*, 471 U.S. at 739-41. The savings clause argument had been used with some success in lower courts. *See* Am. Progressive Life & Health Ins. Co. of New York v. Corcoran, 715 F.2d 784, 787 (2nd Cir. 1983)(insurance regulation establishing maximum commission of salesmen for union pension funds fell within ERISA's savings clause); Eversole v. Metropolitan Life Ins. Co., 500 F.Supp. 1162, 1169-70 (C.D.Cal. 1980)(bad faith denial of claim for medical benefits saved as state common law regulating insurance). *But cf.* Light v. Blue Cross & Blue Shield of Alabama, 790 F.2d 1247, 1249 n.3. (5th Cir. 1986)(distinguishing *Eversole* in that bad faith allegation preempted when plan self-insured).

[70] *Id.* at 739. Appellees did not contest the issue as the Court in *Shaw* had stated conclusively the broad scope of the preemption provision. *Id.* Even indirect state action regarding private pensions encroached on federal ground. Alessi v. Raybestos-Manhattan Inc., 451 U.S. 504, 525 (1981). Section 47B, while not a benefit plan law, did bear indirectly on pension plans, requiring the purchase of mental health benefits. *Metropolitan Life*, 471 U.S. at 739.

[71] *Id.* at 741-42. The appellants argued that the statutes were health laws, only operating on insurance contracts, and not traditional insurance laws, and that neither the savings nor deemer clauses differentiated between traditional and innovative insurance laws. *Id.* The Court stated that a presumption existed against preemption, and that Congress had no intention of preempting areas of traditional state regulation. *Id. Cf. supra* note 28 and accompanying text (*Metropolitan Life* presumption similar to state-directed presumptions of 1930's and 1970's).

[72] *Metropolitan Life*, 471 U.S. at 740-41. The Court was disinclined to read limitations into the savings clause or enlarge the preemptive scope of the deemer clause. Further, legislative history revealed that the savings clause had been in place prior to the revision of the preemption clause and that the preemption clause was not broadened out of concern for state regulation of insurance contracts. *Id.* at 745.

[73] *Id.* at 741. Since ERISA saved only state regulation of insurance, and not state regulation of those who were self insured, self-insured plans would not have to comply with mandated-benefit plans. *See* Sherrick, *supra* note 29, at 1076-77. Commentators have surmised that employers and employee benefit plans will now be encouraged to become self-insured. *Id.* Additionally, ERISA's primary objectives of permitting uniform national coverage of benefit plans have been thwarted, as insured plans in more than one state have been forced to comply with various state mandated-benefit laws. *Id.*

[74] *Metropolitan Life*, 471 U.S. at 743. *See* Union Labor Life Ins. Co. v. Pireno, 458 U.S. 119, 134 (1982)(use of insurance company peer review committee not business of insurance); Group Life & Health Ins. Co. v. Royal Drug Co., 440 U.S. 205, 215-17 (1979)(pharmacy conflicts with insurance company concerning drug prices not business

itan Life Court concluded that the three relevant criteria were applicable to the mandated-benefit law,[75] and that the traditional understanding of insurance regulation included such laws.[76] Therefore, the Court found that the plain meaning of the savings clause allowed state enforcement.[77]

In the wake of multiple Supreme Court rulings preempting the bulk of substantive law surrounding pension plans,[78] further conflicts developed, particularly in the area of damages.[79] In *Massachusetts Mutual Life Insurance Co. v. Russell*,[80] the Court first construed section 1109(a), regarding remedies for breach of fiduciary duty.[81] In *Massachusetts Mutual*, the appellee asserted that extra-contractual damages were statutorily implied, if not expressly authorized.[82] In denying the claim of the appellee, the Court relied on legislative history as ex-

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of insurance).

[75] *Metropolitan Life*, 471 U.S. at 743. *See supra* note 52 and accompanying text. Section 47B regulated the spreading of risk, as the legislature intended that all should share the risk of mental health care. *Metropolitan Life*, 471 U.S. at 743. The law directly regulated the relationship between the insurer and insured as it limited the type of insurance which an insurer sold. *Id.* Finally, the statute affected only insurers. *Id.*

[76] *Id.* at 746.

[77] *Id.* The Court also found that the National Labor Relations Act (NLRA) did not preempt mandated-benefit laws. *Id.* at 747-58. The central concern of the NLRA was protection of collective bargaining, not the particular terms of the bargaining. *Id.* at 753.

[78] *See supra* notes 46 and 59.

[79] *See* Hollenbeck v. Falstaff Brewing Corp., 780 F.2d 20, 21 (8th Cir. 1985)(punitive damages, even if available under ERISA, would not be remedy where actions of employer neither wanton nor malicious); Kuntz v. Reese, 760 F.2d 926, 938 (9th Cir. 1985)(liability of ERISA administrator for $100 per day does not preclude additional award of punitive damages); Gillikin v. Hughes, 609 F. Supp. 178, 182 (D. Del. 1985)(punitive damages may be imposed for wanton, wilful or oppressive breach of fiduciary duty). *But see* Powell v. Chesapeake & Potomac Telephone Co. of Virginia, 780 F.2d 419, 424 (4th Cir. 1985)(phrase "other equitable relief" in § 1132(a)(3) did not permit punitive or extra contractual damages), *cert. denied*, 106 S.Ct. 2892 (1986); Pokratz v. Jones Dairy Farm, 771 F.2d 206, 210 (7th Cir. 1985)(no punitive damages for breach of fiduciary duty).

[80] 473 U.S. 134 (1985).

[81] *Id.* at 139-44. Section 1109(a) provided that the fiduciary should make good any losses to the plan by restoring any profits made through use of the assets of the plan. *Id.* Additionally, the statute made the fiduciary liable for other equitable or remedial relief deemed necessary by the court. *Id.*

[82] *Id.* at 145. Several factors determined whether a private remedy was implicit in the statute. *Id.* (citing Court v. Ash, 422 U.S. 66, 78 (1975)). These factors included whether a plaintiff was a member of the class for whose benefit the legislature enacted the statute and whether the cause of action was traditionally one of state rather then federal law. *Id.* Also indicative was whether the legislature intended to provide or deny a remedy and whether the remedy provided was consistent with the underlying scheme. *Id.*

hibiting more concern for misuse of plan assets than for relief for individual beneficiaries.[83] Seemingly hesitant to read into the statute additional remedies,[84] the Court restricted the recovery in section 1109(a),[85] denying authorization for punitive or extra-contractual damages.[86]

In the instant case, the United States Supreme Court[87] found that the plaintiff's cause of action under the Mississippi law of bad faith[88] "related to" an employee benefit plan,[89] and therefore, held that

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[83] *Massachusetts Mutual*, 473 U.S. at 145-48.

[84] *Id.* at 147. Justice Stevens, author of the opinion, spoke of the civil enforcement provisions of ERISA as "carefully integrated," "interlocking, interrelated, and interdependent," stating he was reticent to "fine tune" the system. *Id.* at 146. However, Justice Brennan, concurring, said these statements were inaccurate, as § 1132(a)(3), providing for other "appropriate equitable relief," appeared to authorize "fine tuning." *Id.* at 155. Brennan added that Congress discussed developing federal common law to deal with welfare and pension plans. *Id.* at 156. Comparison of ERISA provisions with § 301 of LMRA emphasized the development of a body of federal law. *Id.* ERISA did not preclude such a process, Brennan premised, but rather directed its undertaking. *Id.* at 157.

[85] *See* Sommers Drug Stores Co. Employee Profit Sharing Trust v. Corrigan Enters., Inc., 793 F.2d 1456, 1462-63 (5th Cir. 1986)(employee profit-sharing trust could not recover punitive damages for breach of fiduciary duties); Bone v. Ass'n Management Serv., Inc., 632 F.Supp. 493, 496 (S.D. Miss. 1986)(section 1109(a) does not provide extra-contractual damages).; Hutchinson v. Benton Casing Serv., Inc., 619 F.Supp. 831, 834-35 (S.D. Miss. 1985)(same).

[86] *Massachusetts Mutual*, 473 U.S. at 148. While holding that punitive and extra-contractual damages were not available under § 1109(a), the Court reserved the question of such damages under § 1132(a)(3). *Id.* at 148-51. *See also* Howard v. Parisian, Inc., 807 F.2d 1560, 1565 (11th Cir. 1987)(Court did not address availability of punitive or extra-contractual damages under § 1132(a)(3)); *Corrigan*, 793 F.2d at 1462-63 (Court left open issue of punitive damages under § 502(a)(3), but held punitive damages not recoverable by trust). *But see* Powell v. Chesapeake & Potomac Telephone Co. of Virginia, 780 F.2d 419, 424 (4th Cir. 1985)(opportunity to decide issue of § 1132(a)(3), yet denied certiorari), *cert. denied*, 106 S.Ct. 2892 (1986).

[87] Justice O'Connor wrote the opinion for a unanimous court. Pilot Life Ins. Co. v. Dedeaux, 107 S.Ct. 1549, 1550 (1987).

[88] *Id.* at 1553. In the diversity action instituted in 1980 by Dedeaux, he asserted claims under the Mississippi common law for breach of contract, breach of fiduciary duty and fraud. Dedeaux v. Pilot Life Ins. Co., 770 F.2d 1311, 1313 (1985). The Fifth Circuit concluded that the reason Dedeaux failed to assert any claims under ERISA was because ERISA neither expressly nor implicitly authorized punitive damages. *Id.* at 1313 n.3. Dedeaux first raised the claim called "tortious breach of contract" in his complaint on appeal. *Pilot Life*, 107 S.Ct. at 1553. In his brief, the appellant called his claim a breach of the Mississippi law of bad faith. *Id.*

[89] *Pilot Life*, 107 S.Ct. at 1553. The Court noted that there was no dispute that the Mississippi common law causes of action fell within the "expansive sweep" of the preemption clause. *Id.* In prior rulings the Court had given the phrase "relate to" its broad common sense meaning. Metropolitan Life Ins. Co. v. Massachusettes, 471 U.S. 724, 739 (1985)(quoting Shaw v. Delta Air Lines, 463 U.S. 85, 97 (1983)). The Court emphasized

ERISA's preemption clause applied.[90] In addition, the Court noted that the plaintiff's cause of action did not meet the common sense understanding of the savings clause and met only one of the criteria defining the "business of insurance."[91] As such, the savings clause did not apply to the Mississippi law.[92] The Court further found a congressional intent for a narrow construction of ERISA's savings clause[93] as well as

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in particular that the preemption clause was not restricted to laws specifically designed to affect employee benefit plans. *Pilot Life*, 107 S.Ct. at 1553 (quoting *Shaw*, 463 U.S. at 98).

[90] *Pilot Life*, 107 S.Ct. at 1553. The Court concluded that the common law causes of action which Dedeaux raised, alleging improper processing of a benefit claim under an employee benefit plan, met the criteria in § 1144(a) of ERISA. *Id.* Therefore, ERISA expressly preempted such claims unless they fell within an exception, such as the savings clause. *Id.*

[91] *Id.* at 1554-55. The Court relied on the guidelines utilized by *Metropolitan Life* in reasoning that the Mississippi law of bad faith was not a law "regulating insurance" which would save it from preemption under § 1144(b)(2)(A). *Id.* at 1553-54. The Court concluded that a common-sense view of the word "regulate" indicated a law must be specifically directed toward that industry, not merely impact upon it. *Id.* Even though the Mississippi Supreme Court identified the law of bad faith with the insurance industry in Blue Cross & Blue Shield of Mississippi, Inc. v. Campbell, 466 So. 2d 833, 842 (Miss. 1984), the Court found the roots of this law were grounded in general principles of Mississippi tort and contract law. *Pilot Life*, 107 S.Ct. at 1553-54. Further, the Court justified its reasoning in *Metropolitan Life* by distinguishing the mandated-benefits law there at issue from the Mississippi common law of bad faith at issue in *Pilot Life* with regard to the McCarran-Ferguson Act factors. *Id.* The Court in the instant case concluded that the Mississippi common law of bad faith met at most only one criteria. *Id.* at 1555. While the Court granted that the state common law of bad faith concerned the policy relationship between the insurer and insured, it stated that the law did not effect a spreading of policyholder risk. *Id.* at 1554-55. Additionally, the law of bad faith, while associated with the insurance industry, arose from principles of contract and tort law. *Id.* at 1555.

[92] *Pilot Life*, 107 S.Ct. at 1558. The Court felt obliged to consider not only the criteria in *Metropolitan Life* in interpreting the savings clause, but also the role of the clause in ERISA as a whole. *Id.* at 1555. Realizing that in dealing with a statute it could not be guided by a single sentence, the Court looked to the provisions of the whole law, its object and policy. *Id.* (citing Kelly v. Robinson, 107 S.Ct. 353, 358 (1986)). In particular, the Court found congressional intent that the civil enforcement provisions of ERISA be the exclusive vehicle for remedies. *Id.* at 1555.

[93] *Id.* at 1557. The Senate Committee emphasized the uniformity of decision which the Act was designed to foster, enabling participants to "predict the legality of proposed actions without the necessity of reference to varying state laws." *Id.* (quoting H.R. REP. No. 533, 93rd Cong., 2d Sess. 12 (1973), *reprinted in* 2 SENATE COMMITTEES ON LABOR AND PUBLIC WELFARE, LEGISLATIVE HISTORY OF ERISA, 94th Cong., 2nd Sess. 2359 (Comm. Print 1976)). This uniformity was to be gained by development of a body of federal substantive law, dealing with rights and obligations under private welfare and pension plans. *Id.* (quoting 120 CONG. REC. 29,942 (1974)). *See also* Nachwalter v. Christie, 805 F.2d 956, 959 (11th Cir. 1986)(congressional intent of federal courts to create

for remedies on behalf of ERISA plan participants or beneficiaries to be derived exclusively through civil enforcement provisions.[94] Consequently, section 1144(b)(2)(A) was interpreted as not saving the Mississippi law of bad faith.[95] By drawing a comparison between the legislative history of the savings clause and of section 301 of the Labor-Management Relations Act of 1947 (LMRA), the Court determined that ERISA similarily[96] preempted state judgmental law.[97] Therefore, since the Mississippi law of bad faith did not regulate insurance in the manner Congress intended, the law was preempted by ERISA.[98]

The Supreme Court's decision in *Pilot Life* has indicated a strengthening of the federally directed preemption position[99] in its re-

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body of federal common law to govern ERISA); Whitworth Bros. Storage Co. v. Central States, 794 F.2d 221, 233-36 (6th Cir. 1986)(same), *cert. denied*, 107 S.Ct. 645 (1986); Woodfork v. Marine Cooks & Stewards Union, 642 F.2d 966, 972-73 (5th Cir. 1981)(same). *Cf.* Hutchinson & Ifshin, *supra* note 15, at 35 (federal law intended to be "interstitial" or "gap-filling").

[94] *Pilot Life*, 107 S.Ct. at 1556-57. Confirming the legislative history of the civil enforcement provisions, the Court noted that the scheme represented a careful balancing of the requirement for prompt claim settlement against the public interest in having employee benefit plans. *Id.* Therefore, if participants were able to obtain remedies not specified in ERISA, such as punitive damages, the scheme would be undermined. *Id.* The Court mentioned the "six carefully integrated" civil enforcement provisions as evidence that Congress did not intend to authorize remedies which it forgot to include expressly. *Id.* (citing Massachusetts Mutual Life Ins. Co. v. Russell, 473 U.S. 134, 146 (1985)). *See supra* note 7 (for discussion of specific remedies enumerated in civil enforcement scheme of ERISA).

[95] *Pilot Life*, 107 S.Ct. at 1558. In finding the savings clause inapplicable in the instant case, the Court maintained that no conflict existed with regard to its earlier general observations in *Metropolitan Life*. *Id.*

[96] *Id.* at 1557. Section 301 of the LMRA's broad preemptive force displaced all state action relative to contracts between labor and management, even claims seeking relief unavailable under LMRA. *Id.* (citing Allis-Chalmers Corp. v. Lueck, 471 U.S. 202, 220 (1985)). Claims arising under LMRA were to be purely creatures of federal law. Franchise Tax Bd. v. Construction Laborers Vacation Trust, 463 U.S. 1, 23 (1983).

[97] *Pilot Life*, 107 S.Ct. at 1558. The Court rationalized that such a body of federal common law, and, indeed, the comparison of ERISA's civil enforcement procedure to § 301 of LMRA would make little sense if remedies available to ERISA participants and beneficiaries could be "supplemented or supplanted by varying state laws." *Id.* The Court noted that due to the "statutory complexity" of ERISA's three preemption provisions, *Metropolitan Life*, and the "wide variety" of state statutory and judgmental law affected by the federal preemption provisions, it was not surprising that additional interpretation was necessary. *Id.* at 1553.

[98] *Id.* The Court distinguished its decision in *Metropolitan Life* by noting that in that instance the Court had no occasion to consider the issue raised in the instant case. *Id.*

[99] *See supra* note 28 and accompanying text.

iteration of a broad interpretive view of the preemption clause.[100] Following *Pilot Life*, ERISA will preempt any state law that relates to an ERISA provision, directly or indirectly, even if it does not conflict.[101] Such preemption would annul all state substantive law regarding pension and employee benefit plans.[102] In a reversal of its viewpoint in *Metropolitan Life*, the *Pilot Life* Court has narrowed its perception of the savings clause.[103] Instead of presuming against preemption, or hesitating to limit the savings clause, the Court in *Pilot Life* construed the "business of insurance" as saving only laws that regulate, rather than affect insurance.[104] While delineating more clearly its position on preemption, the Court failed to ameliorate the confusion regarding punitive damages.[105]

In substantiating the logic of its reasoning, the Court in *Pilot Life* appears to ignore its prior holdings, and instead mistakenly portrays ERISA as a statutorily complete, detailed example of perfection.[106] This portrayal directly contravenes the legislative history and subsequent Court decisions urging the development of a body of federal common law regarding employee benefit plans.[107] It appears that while the Court has professed to rely on congressional intent and legislative history in *Pilot Life*, its perception regarding these entities is somewhat obscured.[108] Additionally, the Court has taken a more judicially activist stand in this area, probably in reaction to the failure of Congress to clarify ERISA with new legislation.[109] Sensing a weakness in its logic, the Court buttressed its argument with a reference to the conflict doctrine of preemption.[110] While not specifically stating that the

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[100] *See supra* notes 42, 46, 58, 68, 90 and accompanying text.

[101] *See supra* notes 43-46, 48, 49, 57, 90 and accompanying text.

[102] *See supra* note 57.

[103] *See supra* note 91.

[104] *See supra* notes 72, 91 and accompanying text.

[105] *Pilot Life*, 107 S.Ct. at 1556. The Court ignored Brennan's concurrence in *Massachusetts Life*, which had found support in the circuits, indicating that the issue had been settled by that decision. *Id.*

[106] *Id.* at 1556-58. The Court discounted references to the fact that ERISA was not a model of legislative drafting, and that Senator Javits foresaw regulatory "lacunae" or gaps which have been mentioned in other Supreme Court opinions and in the circuits. *See supra* notes 30, 31, 46, 84 and accompanying text. Contrarily, the Court utilized the phrases "deliberate care," "clear expression," "comprehensive legislative scheme," and "carefully integrated statute," giving the impression of wholeness. *Pilot Life*, 107 S.Ct. at 1556-58.

[107] *See supra* notes 57, 84 and 93.

[108] *See supra* notes 46, 66, and *Pilot Life*, 107 S.Ct. at 1556-58.

[108] *See supra* note 66.

[110] *Pilot Life*, 107 S.Ct. at 1558.

Mississippi law of bad faith conflicted with ERISA, the Court inferred that a conflict existed as a justification for its clear departure from *Metropolitan Life*.[111]

In conclusion, by presenting a united front regarding the exclusivity of ERISA, the Supreme Court has indicated a desire to discourage litigation in this area.[112] This desire might well be unrealistic and premature, as several "interstices" remain unfilled, particularly regarding punitive damages.[113] Furthermore, the result of *Pilot Life* will be that interpretation of the "business of insurance" will occur on a case-by-case basis.[114] Judging from the explosion of ERISA cases in the circuits subsequent to *Pilot Life*, it is apparent that the Supreme Court has not established closure with regard to interpretation of ERISA and employee benefit plans.[115]

Dinetia M. Newman

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[111] *Id.*

[112] *See supra* notes 44-47, 51, 52, 58, 91 and accompanying text.

[113] *See supra* notes 86 and 94 (Court in *Massachusetts Mutual* was only partially determinative of issue of punitive damages).

[114] *See supra* note 57 and accompanying text (cases subsequent to *Pilot Life* evidence continuing conflict).

[115] *Id.*

Constitutional Law — Substantive Due Process — Grossly Excessive Corporal Punishment Violates Students' Substantive Due Process Rights

Plaintiff[1] brought an action in the United States District Court for the District of New Mexico against defendants[2] for violations of substantive due process rights[3] under 42 U.S.C. § 1983.[4] The defendants

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[1] The plaintiff, Teresa Garcia, was a nine-year-old, third grade student at the Penasco Elementary School in Penasco, New Mexico. Garcia v. Miera, 817 F.2d 650, 652 (10th Cir. 1987). The action was brought on behalf of the minor by her parents and next friends, Max and Sandra Garcia. *Id.*

[2] *Id.* Suit was filed against Theresa Miera, the school principal; J. D. Sanchez, a teacher; Edward Leyba, an administrative associate; and others in their individual capacities. *Id.*

[3] *Id.* The claim arose as a result of corporal punishment being administered by the school officials. *Id.* For the purposes of this note, corporal punishment is defined as any kind of physical punishment inflicted on the body of a student by school officials. Black's Law Dictionary 306 (Rev. 5th ed. 1979); *see also* Comment, *School Discipline: The Administrator's Dilemma*, 15 Willamette L. Rev. 531, 549 (1979)(defines corporal punishment as "intentional infliction of physical pain to punish misconduct"). Plaintiff alleged that on two separate occasions the beatings she suffered at the hands of the defendants were so severe as to violate her substantive due process rights. *Garcia*, 817 F.2d at 652. In the first incident, Garcia had hit a boy who had kicked her, and the principal, Miera, summoned Garcia to the principal's office for punishment. *Id.* Garcia refused to be paddled and the principal responded by calling another teacher, J.D. Sanchez, for assistance. *Id.* at 653. Sanchez held Garcia upside down by her ankles while Miera hit Garcia five times on the front of the leg between the knee and waist with a wooden paddle. *Id.* The paddle, which was split down the middle, pinched when it hit and caused bleeding and a welt on the child's leg. *Id.* The second beating at issue occurred when Miera attempted to punish Garcia for spreading rumors that defendant Judy Mestas had been seen kissing a student's father, Denny Mersereau, on the school bus during a field trip and that Mestas had sent Mersereau love letters by way of his son. *Id.* Miera then called the administrative associate, E. Leyba, for assistance. *Id.* Initially, Leyba and Garcia struggled until Garcia hit her back on Miera's desk which caused back pains for several weeks. *Id.* Garcia then submitted to three additional blows which caused severe bruises on her buttocks and pain for two to three weeks. *Id.* The plaintiff contended that the severe corporal punishment she was subjected to violated "her clearly established substantive due process rights." *Id.*

[4] *Garcia*, 817 F.2d at 652. The pertinent portion of § 1983 provides that:

> Every person who, under color of any statute, ordinance, regulation, custom, or usage, of any State or Territory or the District of Columbia, subjects, or causes to be subjected, any citizen of the United States or other person within the jurisdiction thereof to the deprivation of any rights, privileges, or immunities secured by the Constitution and laws, shall be liable to the party injured in an action at law, suit in equity, or other proper proceeding for

filed a motion for summary judgment, and the district court granted the motion.[5] On appeal, the United States Court of Appeals for the Tenth Circuit, *held*, reversed and remanded. Where corporal punishment inflicted on students by public school officials is so grossly excessive as to be literally shocking to the conscience, and where the law is clearly established as to the consequences for administering such excessive punishment, school officials will not be shielded by qualified immunity and will be liable for violations of the students' substantive due process rights. *Garcia v. Miera*, 817 F. 2d 650 (10th Cir. 1987).

During the past two decades, judicial recognition of the constitutional rights of public school children[6] has generated many constitutional challenges to the use of corporal punishment in the public school.[7] The first case to present such a challenge was the 1969 district

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redress.

42 U.S.C. § 1983 (1979).

[5] *Garcia*, 817 F.2d at 652. The defendants alleged that they were protected from liability by the defense of good faith immunity of government officials. *Id.* The immunity afforded by a good faith defense is qualified, under which government officials are generally shielded from liability for civil damages where their conduct does not violate constitutional rights and is found to be reasonable as measured by reference to clearly established law. *Id.* at 656; *see* Harlow v. Fitzgerald, 457 U.S. 800, 818 (1982)(qualified immunity is based on objective reasonableness of official's conduct). *But see* Owen v. City of Independence, 445 U.S. 622, 657 (1980)(public body not immune from liability under section 1983 flowing from constitutional violations); McClary v. O'Hare, 786 F.2d 83, 85 (2d Cir. 1986)(state law does not immunize conduct that is wrongful under section 1983). The district court ruled that the law was not clearly established as to whether excessive corporal punishment can give rise to a substantive due process claim. *Garcia*, 817 F.2d at 652. In arriving at its conclusion, the district court relied solely on the fact that the United States Supreme Court refused to address the substantive due process issue in a previous case. *Id.* at 656; *see* Ingraham v. Wright, 430 U.S. 651, 679 n.47 (1977)(Court found no occasion in case to decide whether corporal punishment may give rise to substantive due process claim).

[6] *See, e.g.*, Goss v. Lopez, 419 U.S. 565, 576 (1975)(student entitled to hearing before or shortly after being suspended); Tinker v. Des Moines Indep. Community School Dist., 393 U.S. 503, 506 (1969)(students given limited right to free speech in school); Epperson v. Arkansas, 393 U.S. 97, 109 (1968)(statute that prohibited teaching of theory of evolution struck down).

[7] *See, e.g.*, Glaser v. Marietta, 351 F. Supp. 555 (W.D. Pa. 1972)(plaintiff argued that corporal punishment constituted cruel and unusual punishment); Sims v. Bd. of Educ., 329 F. Supp. 678 (D.N.M. 1971)(plaintiff claimed corporal punishment was violation of due process). *See generally*, Comment, *Corporal punishment in Public Schools: The Legal Questions*, 7 AKRON L. REV. 457, 460 (1974) [hereinafter cited as Comment, *Legal Questions*](analysis of constitutionality of corporal punishment); Comment, *Corporal Punishment in Public Schools: A Violation of Substantive Due Process?*, 33 HASTINGS L.J. 1245, 1255 (1982)[hereinafter cited as Comment, *Corporal Punishment*] (analysis of challenges to corporal punishment) The Constitutional challenges to corporal

court case of *Murphy v. Kerrigan*.[8] In *Murphy*, several parents brought suit[9] in federal court after their children had been corporally punished in a Boston public school.[10] The plaintiffs challenged the use of corporal punishment as a disciplinary measure in the public schools and alleged that its use abridged the students' privileges and immunities granted by the ninth and fourteenth amendments.[11] Those issues, however, never reached litigation.[12] The school system, pursuant to a consent decree, agreed to ban corporal punishment so long as the present school committee remained in office.[13]

Two years later, similar constitutional challenges reached the District Court for the Northern District of Texas in *Ware v. Estes*.[14] In *Ware*, plaintiffs[15] brought suit in federal district court seeking to restrain defendant school officials from administering corporal punish-

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punishment have generally been premised on four separate theories: (1) substantive due process, (2) procedural due process, (3) cruel and unusual punishment and (4) parental rights. *See* Note, *Corporal Punishment in Public Schools: Constitutional Challenge after Ingraham v. Wright*, 31 VAND. L. REV. 1449, 1450-51 (1978)[hereinafter cited as Note, *Challenge After Ingraham*](study of theories used to challenge corporal punishment).

[8] Civil No. 69-1174-W (D. Mass., filed Nov. 6, 1969), cited in Note, *Corporal Punishment in the Public Schools: Murphy v. Kerrigan*, 6 HARV. C.R.-C.L. L. REV. 583, 583 (1971).

[9] Note, *supra* note 8, at 583. Suit was brought against the teachers who had inflicted the punishment, the school principal, and members of the school committee. *Id.*

[10] *Id.* The punishment at issue took place at the Patrick F. Gavin School in Boston, Massachusetts. *Id.* at 583 n.1. In one incident, a teacher, who was punishing fourteen-year-old student Jeannette Watts for alleged misconduct, struck the student on the cheek and caused her to fall as a result of the blow. *Id.* Another teacher clutched Jeannette's hair, forced her to the floor, and slapped her in the face. *Id.* In other disciplinary situations, a teacher punched fourteen-year-old Margaret Populo in the face and ripped a pierced earring from her ear. *Id.* Furthermore, a teacher hit thirteen-year-old James Watts on the palm of each hand with a bamboo rattan, which caused severe pain, a welt, and broken blood vessels. *Id.*

[11] *Id.* at 583. The plaintiffs argued that the use of physical force to discipline school children constituted cruel and unusual punishment in violation of the eighth amendment, a deprivation of liberty without due process of law in violation of the fourteenth amendment, and a violation of procedural due process under the fourteenth amendment. *Id.* Moreover, the plaintiffs charged that the standards regulating the administration of corporal punishment were arbitrary, vague, and overbroad, in violation of the fourteenth amendment. *Id.* at 583 n.5.

[12] *Id.* at 583.

[13] *Id.* at 583.

[14] 328 F. Supp. 657 (N.D. Tex. 1971), *aff'd mem.*, 458 F.2d 1360 (5th Cir. 1972), *cert. denied*, 409 U.S. 1027 (1972).

[15] *Ware*, 328 F. Supp. at 658. The plaintiffs, Douglas Ware and Roderick Oliver, were two minors represented by their fathers. *Id.* Plaintiff Oliver was knocked unconscious by an assistant principal after allegedly directing an obscene remark at him. *Id.*

ment in the Dallas Independent School District without the permission of the parents.[16] The plaintiffs, relying on *Murphy*,[17] contended that such punishment violated rights guaranteed by the fourteenth amendment.[18] In its analysis, the court scrutinized only the rules and policies of the school district for constitutional violations and concluded that those provisions, which were based on a state statute,[19] were constitutional.[20] Although the court recognized that corporal punishment had been abused by many of the teachers within the school district, it refused to apply strict constitutional scrutiny.[21] Instead, the court applied a rational basis standard and dismissed the complaint,[22] reason-

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[16] *Id.* The suit was a class action brought pursuant to FED. R. CIV. P. 23(b) on behalf of all students and parents of the school district who were opposed to corporal punishment as a method of discipline. *Ware*, 328 F. Supp. at 658.

[17] *Ware*, 328 F. supp. at 659. The plaintiffs cited *Murphy* as support for the allegations of denial of due process. *Id.* The court found that *Murphy*, being a consent decree, had little, if any, precedential value. *Id.*

[18] *Id.* at 658. The plaintiffs alleged that corporal punishment administered without parental or student consent was a deprivation of due process under the fourteenth amendment, claiming that any use of such punishment was arbitrary, capricious and wholly unrelated to any legitimate educational purpose. *Id.* Furthermore, the plaintiffs charged that such punishment, on its face, constituted cruel and unusual punishment in violation of the eighth amendment. *Id.*

[19] *Id.* at 660. The statute was TEX. PEN. CODE ANN. art. 1142 (1961), which authorized the school district to use corporal punishment and immunized teachers from assault and battery charges in the moderate use of such punishment. *Ware*, 328 F. Supp. at 660.

[20] *Ware*, 328 F. Supp. at 660. The court refused to pass judgment on the merits of corporal punishment as an educational tool or as a disciplinary measure, but ruled that the evidence was not sufficient to establish that the use of corporal punishment bore no reasonable relation to some purpose within the competency of the state in its educational function. *Id.* The court also ruled that because the school policy of using corporal punishment was authorized by state statute, such policy outweighed any claims based on parental rights. *Id.* In addition, the court determined that since the authorized punishment was lawful, it did not violate the eighth amendment's protection against cruel and unusual punishment. *Id.* However, the court determined that unreasonable or excessive corporal punishment is unlawful and that the perpetrator of it may be liable both criminally and civilly. *Id. See generally* Note, *Constitutional Law - Corporal Punishment - School Policy Permitting Punishment Without Parental Consent Is Not Unconstitutional*, 44 MISS. L. J. 550, 552-53 (1973)(analysis of rulings in *Ware*).

[21] *Ware*, 328 F. Supp. at 660.

[22] *Id.* at 659-60. Applying the rational basis standard, the court found that the use of corporal punishment was a legitimate means of attaining classroom order and thereby rejected the substantive due process challenges. *Id. See generally* Note, *Challenge After Ingraham*, *supra* note 7, at 1459 (examination of levels of scrutiny applied in substantive due process cases). After *Ware*, other lower courts continued to apply a rational basis standard to reject substantive due process challenges. *See, e.g.*, Gonyaw v. Gray, 361 F. Supp. 366, 369 (D. Vt. 1973)(court found corporal punishment reasonably related to legitimate purpose of school discipline); Sims v. Board of Educ., 329 F. Supp. 678, 685

ing that the common law afforded adequate remedies in cases in which the punishment was unreasonable or excessive.[23]

This same rational basis standard was applied four years later by the District Court for the Middle District of North Carolina in *Baker v. Owen*.[24] In *Baker*, a student and his mother brought an action against school officials alleging that the administration of corporal punishment to the student over his mother's objections violated their constitutional rights.[25] In rejecting the plaintiffs' claims, the court balanced the plaintiffs' fourteenth amendment liberty interests against the countervailing interest of the state in maintaining order in the schools.[26] Having found that corporal punishment was rationally re-

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(D.N.M. 1971)(corporal punishment relevant to legitimate functions of common school education).

[23] *Ware*, 328 F. Supp. at 660. These common law remedies include state civil actions in tort and criminal actions for assault and battery. *See generally*, Comment, *Liability of Public School Teachers and School Boards for the Use of Corporal Punishment*, 8 S.U.L. Rev. 161, 164 (1981)(analysis of remedies available for severe corporal punishment).

[24] 395 F. Supp. 294 (M.D.N.C. 1975)(three-judge panel), *aff'd* 423 U.S. 907 (1975)(affirmance restricted to parental rights issue).

[25] *Baker*, 395 F. Supp. at 295-96. The plaintiffs were Russell Carl Baker, a sixth-grade student, and his mother. The action was brought against a North Carolina public school principal and others, alleging that the constitutional rights of the parent and child had been violated when a teacher paddled Russell Carl. *Id.* The paddling occurred on December 6, 1973, and resulted from Russell Carl's alleged violations of his teacher's announced rule against throwing kickballs except during play periods. *Id.* Prior to the spanking, Mrs. Baker had requested that her son not be corporally punished. *Id.* Nevertheless, shortly after the alleged misconduct of Russell Carl, his teacher administered two licks to his buttocks in the presence of another teacher and in view of other students. *Id.* at 296. Mrs. Baker claimed that the administration of this punishment after her objections violated her parental right to control the means of discipline for her children. *Id.* In addition, Russell Carl claimed that he was denied procedural due process and that the punishment itself constituted cruel and unusual punishment. *Id.* Both plaintiffs challenged the constitutionality of N.C. Gen. Stat. §§ 115-146 (1971), which authorized the use of corporal punishment. *Baker*, 395 F. Supp. at 296. The plaintiffs alleged that the statute was unconstitutional since it allowed corporal punishment without procedural due process and over the parents' objections. *Id.*

[26] *Baker*, 395 F. Supp. at 296. Relying on United States Supreme Court cases that acknowledged the constitutional stature of parental rights, the court found that Mrs. Baker had a fourteenth amendment right as a parent to choose the disciplinary means for her children. *Id.* at 299; *see* Prince v. Massachusetts, 321 U.S. 158, 166 (1944)(found custody and care of child resided first in parents); Pierce v. Society of Sisters, 268 U.S. 510, 534-35 (1925)(struck down statute that interfered with parents' right to direct upbringing of children); Meyer v. Nebraska, 262 U.S. 390, 399 (1923)(struck down statute that interfered with parents' right to have children learn foreign language). However, the court ruled that this constitutional right was neither absolute, nor fundamental. *Baker*, 395 F. Supp. at 299. Moreover, the court found that Russell Carl had a fourteenth

lated to the state's legitimate interest, the district court concluded that the plaintiffs' interests were overborne by the greater state interest and accordingly upheld the right of school officials and teachers to administer reasonable corporal punishment for disciplinary purposes.[27]

Similar reasoning was again applied one year later when the United States Court of Appeals for the Fifth Circuit decided the case of *Ingraham v. Wright*.[28] In *Ingraham*, pupils[29] in a Florida junior high school sought damages and injunctive relief, alleging that school officials had violated their substantive due process rights by subjecting them to severe and brutal corporal punishment[30] that was wholly unre-

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amendment liberty interest in avoiding corporal punishment. *Id.* at 301. Accordingly, the court set forth certain minimum procedural safeguards to protect the students' interest without undercutting the disciplinary value of the punishment. *Id.* at 302. Those procedures included: (1) the student must be forewarned that specific misbehavior could occasion the use of corporal punishment, (2) the punishment must be administered in the presence of a second school official, who must be informed beforehand of the reasons for the punishment, and (3) the official who administered the punishment must provide the student's parent, upon request, a written explanation of his reasons for punishment and the name of the second official who witnessed the punishment. *Id.* at 302-03.

[27] *Baker*, 395 F. Supp. at 299-301. The court found N.C. GEN. STAT. §§ 115-146 to be constitutional on its face. *Baker*, 395 F. Supp. at 303. The court also ruled that the spanking in question did not amount to cruel and unusual punishment. *Id.* The spanking was administered by a female teacher and consisted of two licks with a wooden drawer divider that was only slightly longer and thicker that a foot-ruler. *Id.* Russell Carl testified that the paddling produced a stinging sensation, but no lasting discomfort. *Id.* Furthermore, Mrs. Baker testified that the paddling produced two bruises on her son's buttocks, but she did not claim that the bruises were severe, and there was no evidence of a hematoma. *Id.* From these facts, the court concluded that the paddling of Russell Carl did not amount to the type of beating that could constitute cruel and unusual punishment within the meaning of the eighth amendment. *Id.*

[28] 525 F.2d 909 (5th Cir. 1976)(en banc), *aff'd on other grounds*, 430 U.S. 651 (1977).

[29] *Id.* at 911. Plaintiffs in this case were James Ingraham and Roosevelt Andrews, two junior high school students enrolled in a Dade County, Florida, school. *Id.* Plaintiffs filed individual claims under 42 U.S.C. §§ 1981-1988 (1964), and also filed suit as representatives of the class of students of the Dade County School System. *Ingraham*, 525 F.2d at 911.

[30] *Ingraham*, 525 F.2d at 911. Plaintiff Ingraham received twenty blows with a wooden paddle from the school principal for disruption of class. *Id.* Two assistant principles held Ingraham, who had initially refused to be paddled, against a table while the punishment was administered. *Id.* The paddling produced a hematoma, requiring medical attention and bed rest for ten days. *Id.* Plaintiff Andrews complained of two incidents of severe corporal punishment. *Id.* First, Andrews testified that a school official struck him on the arm, back, and neck, for tardiness and resisting punishment. *Id.* In the second incident, the school principal paddled Andrews on the backside and the wrist for allegedly breaking glass in a sheet metal class. *Id.* As a result of this paddling, Andrews suffered an injured wrist requiring medical attention and pain pills. *Id.*

lated to achieving any legitimate educational goal.[31] In assessing this issue, the court examined the Florida statutory provisions and the school board's policy statement[32] and found that, together, they reflected a legitimate state purpose, thereby eliminating any arbitrary or capricious element in the practice.[33] Furthermore, the court refused to scrutinize individual incidents to determine whether the punishment, as administered, was arbitrary or capricious, noting, as in *Ware*, the availability of criminal and civil remedies.[34] The court reasoned that an

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[31] *Id.* Plaintiffs also claimed that corporal punishment of school children amounted to cruel and unusual punishment and that the school system's policies for corporal punishment violated fourteenth amendment due process standards by failing to provide any procedural safeguards before administering punishment. *Id.* at 911-12.

[32] *Id.* at 915-16. The statute in question, implicating the use of corporal punishment in Florida public schools, provided:

> Each teacher or other member of the staff of any school shall assume such authority for the control of pupils as may be assigned to him by the principal and shall keep good order in the classroom and in other places in which he is assigned to be in charge of pupils, but he shall not inflict corporal punishment before consulting the principal or teacher in charge of the school, and in no case shall punishment be degrading or unnecessarily severe in its nature.

FLA. STAT. ANN. § 232.27 (1961). The policy in question was the Dade County School Board Policy 5144 which explicitly authorized corporal punishment and set forth guidelines under which it was to be administered:

> In the administering of corporal punishment, no instrument shall be used that will produce physical injury to the student, and no part of the body above the waist or below the knees may be struck. The person administering the corporal punishment must realize his own personal liabilities if the student being given corporal punishment is physically injured.

Ingraham, 525 F.2d at 916 n.6.

[33] *Ingraham*, 525 F.2d at 916-17. The court reasoned that the maintenance of discipline and order in the class rooms was necessary to establish an effective learning atmosphere, and determined that the practice of corporal punishment effectively served this legitimate function. *Id*; *see also* Sims v. Waln, 388 F. Supp. 543, 546 (S.D. Ohio 1975)(corporal punishment necessary to maintain good order in schools); Gonyaw v. Gray, 361 F. Supp. 366, 369 (D. Vt. 1973)(corporal punishment reasonably related to legitimate purpose of school discipline); Sims v. Board of Educ., 329 F. Supp. 678, 685 (D.N.M. 1971)(court found corporal punishment relevant to functions of common school education). *But see* Comment, *Corporal Punishment in the Schools: A Time for Change*, 4 J. JUV. L. 155, 167-69 (1980)(positive reinforcement and other alternatives preferred over corporal punishment); Note, *Challenge After Ingraham*, *supra* note 7, at 1471 (severe punishment unrelated to state's goals); Note, *supra* note 20, at 554 (analysis of harmful effects of corporal punishment).

[34] *Ingraham*, 525 F.2d at 917. The court also held that the cruel and unusual punishment clause of the eighth amendment applied only to punishment invoked as a sanction for criminal offenses. *Id.* at 913. Additionally, the court ruled that procedural safeguards are not required prior to administering corporal punishment since no grevious loss would result in their absence and the procedures would dilute the effectiveness of

examination of specific incidents would be a misuse of judicial power, emphasizing that the decision as to the appropriate measure of punishment is a judgment to be made by the school officials, not the courts.[35] Because the United State Supreme Court in its review of *Ingraham* denied certiorari on the substantive due process issue,[36] the resolution of that issue in *Ingraham* was binding only in the Fifth Circuit.[37] As a result, changes in the law began to develop in other circuits.[38]

For example, four years after *Ingraham*, the question of whether excessive corporal punishment violated students' substantive due process rights was at issue in the Fourth Circuit case of *Hall v. Tawney*.[39] In its analysis, the court determined that the availability of state criminal and civil remedies did not preclude a federal cause of action under section 1983 when rights to substantive due process may be implicated.[40] The court ruled, therefore, that although disciplinary corporal punishment does not per se violate the students' substantive due process rights,[41] a cognizable claim may be stated when it is based upon an

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the punishment. *Id.* at 917-19.

[35] *Id.* The court determined that it should not substitute its own judgment for that of the school officials in deciding, for example, whether five licks would have been more appropriate than ten licks in a particular instance of misconduct. *Id.*

[36] *Ingraham*, 430 U.S. at 659 n.12. The United States Supreme Court granted certiorari on the issues of cruel and unusual punishment and procedural due process. *Id.* at 651. The Court ruled that the eighth amendment applied only in criminal cases and that the availability of common law remedies satisfied procedural due process. *Id.* at 664, 672. Commentators have criticized the Court's refusal to decide the substantive due process issue as an attempt to avoid resolution of a difficult issue. *See* Rosenberg, *Ingraham v. Wright: The Supreme Court's Whipping Boy*, 78 COLUM. L. REV. 75, 101 (1978)(critical analysis of *Ingraham* decision).

[37] Note, *Challenge After Ingraham*, *supra* note 7 at 1459-60. *See* United States v. Carson, 793 F.2d 1141, 1147 (10th Cir. 1986)(court ruled that decisions of one circuit court of appeals are not binding on another circuit); Jones v. Parmer, 421 F. Supp. 738, 740 (S.D. Ala. 1976)(court followed *Ingraham* and dismissed substantive due process claim in school corporal punishment contest).

[38] *See generally* Note, *Corporal Punishment and the Substantive Due Process Rights of School Children*, 83 W. VA. L. REV. 675, 677 (1981)(analysis of developments in Fourth Circuit).

[39] 621 F.2d 607 (4th Cir. 1980).

[40] *Id.* at 612. In its decision, the court relied on Monroe v. Pape, 365 U.S. 167, 183 (1961) in which the Supreme Court held that relief under § 1983 was supplementary to state remedies. Hall, 621 F.2d at 612; *see also* Doe (A) v. Special School Dist. of St. Louis County, 637 F. Supp. 1138, 1145 (E.D. Mo. 1986)(court found allegations of constitutional deprivations sufficient to state claim under § 1983 despite availability of common-law remedies); Madden v. City of Meriden, 602 F. Supp. 1160, 1166 (D. Conn. 1985)(availability of state remedies did not bar § 1983 action to vindicate violation of substantive due process).

[41] *Hall*, 621 F.2d at 611. The court recognized that corporal punishment per se was

episodic application of force that goes beyond that which is authorized by state law or policy.[42] Emphasizing the difference between state and federal claims, the court reasoned that in the resolution of a state tort claim of assault and battery, the decision may turn on whether the number of licks administered was excessive.[43] However, in a substantive due process claim, the court determined that the violations of personal rights may be of such magnitude that inquiry into the particular case need not begin with such refined line-drawing.[44] The court then set forth the following test for determining a due process violation:

> [T]he substantive due process inquiry in school corporal punishment cases must be whether the force applied caused injury so severe, was so disproportionate to the need presented, and was so inspired by malice or sadism rather than a merely careless or unwise excess of zeal that it amounted to a brutal and inhumane abuse of official power literally shocking to the conscience.[45]

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reasonably related to the legitimate state interest in maintaining order in the schools. *Id.* at 612.

[42] *Id.* at 614. The court reasoned that the use of corporal punishment is not privileged and must be limited by the individual's constitutional right to bodily security. *Id.* at 612-13. Commentators have suggested that school children are more likely to be successful in challenges to severe corporal punishment if their interest in being free from such punishment is recognized as a fundamental right and is given strict scrutiny. *See generally* Note, *Challenge After Ingraham*, *supra* note 7, at 1471 (analysis of levels of review utilized in constitutional rights cases).

[43] *Hall*, 621 F.2d at 613.

[44] *Id.*

[45] *Id.* In formulating this test, the court relied on the cognate police brutality cases, having found that the constitutional rights given protection under substantive due process were grounded in these cases. *Id.*; *see* Rochin v. California, 342 U.S. 165, 174 (1952)(forcible use of stomach pump by police); Johnson v. Glick, 481 F.2d 1028, 1033 (2d Cir. 1973)(unprovoked beating of pretrial detainee by guard); Jenkins v. Averette, 424 F.2d 1228, 1232 (4th Cir. 1970)(reckless shooting of suspect by police). While recognizing the need for substantive due process protection, commentators have criticized the test established in *Hall* as being potentially confusing because it failed to set forth whether some or all of the test factors need be met before substantive due process is violated. *See* Note, *Constitutional Law - Public School Children's Right to Substantive Due Process and Federal Relief Under Section 1983 for Excessively Severe Corporal Punishment - Hall v. Tawney*, 17 WAKE FORREST L. REV. 72, 87 (1981)(discussed problems in *Hall* test). Furthermore, the test failed to set forth a workable standard for determining when a tortious battery crosses the constitutional threshold. *See* Kidd v. O'Neil, 774 F.2d 1252, 1253 (4th Cir. 1985)(court found underlying theory of *Hall* test to be flawed); Henderson, *Constitutional Implications Involving the Use of Corporal Punishment in the Public Schools: A Comprehensive Review*, 15 J. L. & EDUC. 255, 263 (1986)(analyzed weakness of *Hall* test). *See also* Comment, *Corporal Punishment*, *supra*

Having found the alleged facts sufficient to state a substantive due process claim,[46] the court remanded the cause to the district court for an adjudication on the merits.[47]

Two years after *Hall*, the Tenth Circuit also gave recognition to a substantive due process claim when it decided *Milonas v. Williams*.[48] In *Milonas*, former students of a Utah correctional school[49] brought an action to enjoin the use of unnecessary physical force as a means of discipline, alleging that such force violated their due process rights.[50] Although the school involved was a correctional and detention facility, the court recognized that students in such a facility clearly had the right to be free from unreasonable bodily restraints and the right to reasonably safe conditions.[51] The court applied a balancing test between the interest of students in personal security and the need of schools to maintain order and found that the disciplinary practices in question were so abusive as to overcome the legitimate administrative and security interests of the school.[52] In upholding the issuance of a

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note 7, at 1269 (*Hall* test too strict to determine constitutional violations).

[46] *Hall*, 621 F.2d at 614. The complaint alleged that a teacher, without apparent provocation, struck the plaintiff, a sixth grade student, with a hard, thick rubber paddle, violently shoved the student against a large stationary desk in an ensuing struggle, and then struck her repeatedly and violently. *Id.* As a result, the child was taken to a hospital where she remained for 10 days and was treated for traumatic injuries to the tissues of her thigh and buttocks and was treated by specialists for possible permanent injuries to her lower back and spine. *Id.*

[47] *Id.* at 615. Although *Hall* allowed a cause of action based on violations of substantive due process, there was no adjudication on the merits because the parties settled the case after remand to the district court. Note, *Constitutional Law - Fourteenth Amendment - Due Process Clause - Civil Rights - Section 1983 - Corporal Punishment - Hall v. Tawney, 621 F.2d 607 (4th Cir. 1980)*, 19 DUQ. L. REV. 801, 805 n.31 (1981).

[48] 691 F.2d 931 (10th Cir. 1982).

[49] *Id.* at 934. Plaintiffs, Timothy Milonas, Jr., age 15, and Kenneth Rice, age 16, brought an action against the owners and operators of the Provo Canyon School and also against various agencies, officers, and employees of the State of Utah. *Id.* The school involved was a correctional school for boys between the ages of 12 and 17 and was located near Provo, Utah. *Id.*

[50] *Id.* Plaintiffs claimed that the use of a disciplinary practice nicknamed the "hair dance" involved unreasonable force. *Id.* at 941-42. The practice involved a teacher grabbing a student by the arm with one hand and clutching the boy's hair with the other hand. *Id.* at 942. This practice was explicitly outlined in the Provo Canyon School Manual for use in dealing with belligerent students. *Id.*

[51] *Id.* In its analysis, the court relied on United States Supreme Court decisions which had given constitutional rights to persons involuntarily confined. *Id.*; *see, e.g.*, Youngberg v. Romero, 457 U.S. 307, 324 (1982)(constitutional rights recognized for inmates of mental institutions).

[52] *Milonas*, 691 F.2d at 942-43. The court therefore affirmed the lower court's decision, reasoning that the balancing approach used by the lower court and its conclusions

permanent injunction against such practices, the court concluded that the defendants' actions had violated the plaintiffs' substantive due process rights.[53]

One year after *Milonas*, the substantive due process issue reappeared in the Fifth Circuit in the case of *Hale v. Pringle*.[54] However, the *Hale* court concluded that the claim was without merit.[55] In its determination of whether the spanking of a student violated his right to substantive due process, the court, while acknowledging the *Hall* decision, ruled that it was bound by the Fifth Circuit's decision in *Ingraham* which did not recognize such claims.[56] The court further determined that, even if it could adopt the principle that the infliction of excessive corporal punishment violates substantive due process rights,[57] the simple spanking presented by the evidence was insufficient to substantiate such a violation.[58]

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of law were in accord with the applicable cases. *Id.*; *see* Nelson v. Heyne, 491 F.2d 352, 357 (7th Cir. 1974)(invalidated use of excessive physical force); Pena v. New York State Div. for Youth, 419 F. Supp. 203, 208 (S.D.N.Y. 1976)(found use of isolation rooms for punishment unconstitutional).

[53] *Milonas*, 691 F.2d at 943. The court noted that several parents had consented to their children being subjected to the disciplinary measures used at the school, however, the court held that the children had constitutionally protected fundamental rights and that the parents could not authorize the state to limit children's liberty interests without a showing of good cause. *Id.* The court therefore affirmed the trial court's injunction against the disciplinary practices at issue. *Id.*

[54] 562 F. Supp. 598 (M.D. Ala. 1983).

[55] *Id.* The plaintiff, Shirley Hale, as the mother of Shawn Hale and in her own behalf, brought an action against the Lowndes County High School officials, alleging that the spanking of her son violated his substantive due process rights. *Id.* at 599. The school principal administered the spanking as punishment for fighting, and it consisted of three to five licks with a paddle. *Id.* As a result of the paddling, Shawn suffered minor bruises to his buttocks and a small bruise to the smallest finger on his right hand, which had apparently been in the way as he was being paddled on the buttocks. *Id.* at 600. The court cited *Ingraham* as precedent and held that the simple spanking of a student would not violate substantive due process rights. *Id.* Also, the court stated that the *Ingraham* decision has established that the use of excessive force in administering corporal punishment does not give rise to a substantive due process claim. *Id.*

[56] *Id.* at 601; *see also* Coleman v. Franklin Parish School Bd., 702 F.2d 74, 76 (5th Cir. 1983)(court relied on *Ingraham* and dismissed substantive due process claim of student who had been cut on his head when hit with coffee cup); Rhodus v. Dumiller, 552 F. Supp. 425, 428 (M.D. La. 1982)(court followed *Ingraham* and refused substantive due process claim of student who had been hit in kidneys by his coach).

[57] *Hale*, 562 F. Supp. at 601. The court stated that it was bound by the former Fifth Circuit decision in *Ingraham* and would remain bound by the decision until the United States Supreme Court or the current Eleventh Circuit overturned it. *Id.*

[58] *Id.* at 601 n.3. The court was of the opinion that the simple spanking which consisted of only three to five licks was reasonable, not excessive. *Id.*; *see also* Rubek v.

A similar case in which the facts alleged were held to be insufficient to establish a substantive due process violation was the district court case of *Brooks v. School Board of Richmond, Virginia.*[59] In *Brooks*, the controversy surrounded the conduct of a teacher who allegedly pierced the upper arm of a student with a straight pin for disciplinary reasons.[60] In determining whether the student's substantive due process rights had been violated by the teacher's actions, the court compared the severity of the disciplinary measure with those in *Ingraham* and *Hall.*[61] Having found that the plaintiff had suffered no excessive trauma, the court determined that a mere jab with a straight pin could not equate to beatings and massive bruising and did not shock the conscience as required in *Hall.*[62] Furthermore, since the plaintiff had failed to allege the teacher's intent to deprive her of a specific constitutional right, the court ruled that the plaintiff had failed to state a cause of action for a constitutional tort.[63]

Eight years after *Ingraham*, the Fifth Circuit again faced the substantive due process issue in *Woodard v. Los Fresnos Independent*

Barnhart, 814 F. 2d 1283, 1285 (8th Cir. 1987)(no liability of school officials where punishment did not violate rights of constitutional magnitude); Coffman v. Kuehler, 409 F. Supp. 546, 549 (N.D. Tex. 1976)(court found that blows administered to student were not unreasonable in relation to offense committed).

[59] 569 F. Supp. 1534 (E.D. Va. 1983).

[60] *Id.* at 1535. Plaintiff Brooks brought this action under 42 U.S.C. § 1983 (1979), seeking money damages and alleging violations of her substantive due process right to be free from physical intrusions upon her person and from punishment while in the care of school authorities. *Brooks*, 569 F. Supp. at 1535. As a result of being stuck with the pin, plaintiff further alleged that she suffered physical injury and psychological consequences, both of which required medical attention. *Id.*

[61] *Brooks*, 569 F. Supp. at 1536. In *Ingraham*, the punishment consisted of twenty licks with a two-foot-long paddle, which caused a severe hematoma. *Id.* The punishment complained of in *Hall* was a violent beating resulting in hospitalization. *Id.*

[62] *Id.* The court further reasoned that the pin-sticking could not shock the conscience of the court since other apparently more serious allegations that had reached the United States Supreme Court had failed to shock the conscience. *Id. See, e.g.*, Baker v. McCollan, 443 U.S. 137, 146 (1979)(false imprisonment); Paul v. Davis, 424 U.S. 693, 710 (1976)(defamation); Estelle v. Gamble, 429 U.S. 97, 107 (1976)(medical malpractice). The court, therefore, concluded that the plaintiff had not alleged facts sufficient to even suggest a substantive due process claim. *Brooks*, 569 F. Supp. at 1536.

[63] *Brooks*, 569 F. Supp. at 1539. In its decision, the court relied on two police brutality cases to determine whether a constitutional violation had taken place rather than a mere tort violation. *Id.* at 1538; *see* Screws v. United States, 325 U.S. 91, 103 (1944)(no constitutional violation unless tort has deprived victim of right secured by Constitution); Dandridge v. Police Dept. of Richmond, 566 F. Supp. 152, 160 (E.D. Va. 1983)(constitutional right infringed only when defendant intended to abridge that right).

School District.[64] In *Woodard*, a high school student[65] claimed that she had been denied due process when she was given a spanking for disciplinary reasons.[66] In its analysis, the court looked to both *Ingraham* and *Hall* to determine when corporal punishment may result in a deprivation of substantive due process.[67] The court found allegations of the administration of three swats presented neither arbitrary state action nor shocking abuse of official power.[68] The court, therefore, did not reevaluate the earlier refusal in *Ingraham* to examine individual incidents for conformity with substantive due process and accordingly affirmed the lower court's dismissal of the action.[69]

In the instant case, the court recognized that personal privacy and

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[64] 732 F.2d 1243 (5th Cir. 1984).

[65] *Id.* at 1244. The plaintiff was Rayella Woodard, a 16-year-old student at Los Fresnos High School. *Id.* The action was filed by her father as her guardian and was brought against the school officials. *Id.*

[66] *Id.* The spanking in question involved three punitive strikes with a paddle which were administered by a female physical education instructor as punishment for the plaintiff's use of abusive language to a school bus driver. *Id.* The assistant principal had offered Woodard three punishment options including a three week exclusion from the bus, suspension from school for three days or three swats with a paddle. *Id.* Woodard's mother, after having discussed the matter with the assistant principal, chose the three day suspension option for her daughter. *Id.* The district rules provided that the choice of punishment was to be made by the parents. *Id.* at 1244. However, the student refused that option because her grades would suffer and chose the paddling instead. *Id.* The plaintiff then alleged that a constitutional violation had occurred since the school official accepted the juvenile's decision concerning her punishment rather than her mother's. *Id.* Ironically, the plaintiff alleged that it was her own constitutional right that had been violated, rather than her parents' rights, when her decision had been accepted. *Id.* *See generally*, Digest, *Corporal Punishment and School Discipline*, 9 J. Juv. L. 178, 179 (1985)(analysis of issues in *Woodard*). The court perceived this argument as an attempt by the plaintiff to characterize a procedural violation as arbitrary and capricious conduct amounting to a denial of substantive due process. *Woodard*, 732 F.2d at 1246. The court, therefore, found no merit to the claim. *Id.*

[67] *Woodard*, 732 F.2d at 1246. The court stated that under the *Ingraham* test, corporal punishment violates substantive due process rights when it is capricious, arbitrary, or unrelated to the goal of maintaining a conducive learning atmosphere. *Id.* The court noted that the inquiry in *Hall* was whether the force applied was so severe and inspired by malice that it amounted to an abuse of official power and shocked the conscience. *Id.*

[68] *Id.* Although the court implied that it may someday reevaluate *Ingraham*, it reasoned that in this particular instance the spanking was at most a tort for which state courts could provide relief, especially since the student had failed to allege any injury or undue severity in the administration of the paddling. *Id.* at 1244-45. Moreover, the court ruled that every tort committed by a state official does not amount to a violation of constitutional rights. *Id.* at 1244.

[69] *Id.* at 1246. The court stated that there was no need to reevaluate the *Ingraham* decision in light of *Hall* because under both the *Ingraham* and *Hall* tests the facts would be insufficient to establish a substantive due process violation. *Id.*

bodily security were liberty interests long recognized at common law,[70] and that *Ingraham* established that the infliction of significant physical pain implicated such fourteenth amendment liberty interests.[71] On that basis, the court held that the use of corporal punishment may affect fundamental rights protected by substantive due process.[72] The court then reaffirmed *Milonas*[73] and held that an excessive degree of corporal punishment violates the substantive due process rights of the pupil.[74] Regarding the facts of the instant case, the court held that there was sufficient evidence to support the allegations of severe and brutal beatings,[75] and that previous similar cases had established the

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[70] *Garcia*, 817 F.2d at 654 (quoting Ingraham v. Wright, 430 U.S. 651, 673-74 (1977)(right to be free from unjustified personal intrusions and bodily restraint have been long recognized by common law)). *See* Meyer v. Nebraska, 262 U.S. 390, 399 (1923)(fundamental liberty interest involved freedom from unwarranted intrusions on personal security including bodily restraint and punishment).

[71] *Garcia*, 817 F.2d at 654. *See* Ingraham v. Wright, 430 U.S. 651, 674 (held punishment by appreciable physical pain affected constitutionally protected liberty interests).

[72] *Garcia*, 817 F.2d at 654. The court held that since the *Ingraham* decision stated that punishment by inflicting pain implicated fourteenth amendment liberty interests, then corporal punishment does affect substantive due process rights. *Id.*

[73] *Id.* at 655 (citing Milonas v. Williams, 691 F.2d 931 (10th Cir. 1982) *cert. denied*, 460 U.S. 1069 (1983)). The court stated that *Ingraham* was not in conflict with *Milonas* because *Ingraham* upheld only "limited" and reasonable corporal punishment. *Garcia*, 817 F.2d at 654. The Court in *Ingraham* applied a balancing test between the pupil's interest in personal security and the traditional view that a school may need to impose reasonable corporal punishment in appropriate situations. *Ingraham*, 430 U.S. at 676. Although the Court determined that ordinary corporal punishment violates no substantive due process rights of students, it acknowledged that such punishment implicates a fundamental liberty interest protected by the due process clause. *Id.* The Court, therefore, ruled that disciplinary corporal punishment must stay within the boundaries of the common-law privilege. *Id.*

[74] *Garcia*, 817 F.2d at 654. The substantive due process inquiry in school corporal punishment cases is whether the force applied is so brutal or offensive to human dignity as to be literally shocking to the conscience of the court. *Id. See* Milonas v. Williams, 691 F.2d 931, 942 (10th Cir. 1982) *cert. denied*, 460 U.S. 1069 (1983)(disciplinary action whereby school employee would grab student by his hair was unreasonably harsh and violated student's substantive due process rights); Hall v. Tawney, 621 F.2d 607, 612-13 (4th Cir. 1980)(court ruled that student has substantive due process right to be free from brutal, demeaning, and excessive paddling by public school officials). *Cf.* Rochin v. California, 342 U.S. 165, 172 (1952)(forcible use of stomach pump by police officers deprived suspect of liberty without due process of law).

[75] *Garcia*, 817 F.2d at 658. The allegations of the first beating, that the girl was held by her ankles and hit with a paddle on the front of her legs until they bled, were supported by evidence of a permanent scar. *Id.* The allegations with respect to the second beating whereby the punishment caused severe pain for several weeks were supported by pictures of the bruised buttocks, an affidavit from examining doctor stating that he had never in his long years of experience seen such extensive bruises from routine spankings,

appropriate legal principles,[76] thus placing the defendants on notice that egregious invasions of a student's personal security were unconstitutional.[77] The court concluded that recovery on the constitutional tort for excessive corporal punishment was possible and therefore the defendants motion for summary judgment should have been denied.[78]

Despite the Supreme Court's refusal in 1977 to grant certiorari to the substantive due process issue,[79] numerous courts have since recognized the need to provide a constitutional remedy for school children

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and an affidavit from the school nurse stating that if a child had received this type injury at home she would have reported it as child abuse. *Id.* The court noted that although the allegations may not survive the test of the trial, they were sufficient to overcome the defendant's motion for summary judgment. *Id.*

[76] *Id.* at 657-58. The court adopted the approach that there was some factual correspondence between the cases establishing the law and the case at hand. *Id.* The court also required that school officials apply general, well-developed principles of law. *Id.* The court found that *Milonas* and *Ingraham* were sufficiently analogous to the facts of the case at hand and accordingly, the court ruled that these cases clearly established that excessive corporal punishment could deny substantive due process. *Id. See* Harlow v. Fitzgerald, 457 U.S. 800, 818 (1982)(Court ruled that officials need not anticipate subsequent legal developments, but must apply general legal principles in appropriate factual situations); People of Three Mile Island v. Nuclear Regulatory Comm'n, 747 F.2d 139, 144 (3rd Cir. 1984)(court determined that officials are not required to predict future course of constitutional law, but are expected to relate established law to similar factual settings).

[77] *Id.* The court ruled that the defendants were on notice that corporal punishment could violate substantive due process because the law had been clearly established prior to the alleged beatings. *Id.* With respect to the second beating, which occurred on May 13, 1983, the court found that the legal principles to be applied in corporal punishment cases had been clearly set forth in the factually similar *Milonas* decision. *Id. See Milonas*, 691 F.2d at 942-43 (found physical abuse unrelated to state's objectives). Although the defendants claimed that *Milonas* was not decided long enough before the May 13 beating to put them on notice of potential violations, the court determined that the publication of advance sheets, as well as the availability of the decision much earlier by various other reporting services, were sufficient to provide notice. *Garcia*, 817 F.2d at 657 n.10. The court found that the first beating, which occurred on February 10, 1982, before the *Milonas* decision, presented a closer question as to whether the law was clearly established. *Id.* at 657. The court, however, relied on the language as set forth in *Ingraham* and found the law was clear that some high level of force in a corporal punishment context could violate substantive due process. *Id.* at 658; *see* Parratt v. Taylor, 451 U.S. 527, 553 n.11 (1981)(abuse of official power in corporal punishment situation violated students' due process rights); Ingraham v. Wright, 430 U.S. 651, 674 (1977)(corporal punishment can affect fundamental right). The court further reasoned that a reasonably competent legal advisor to a school district should have realized that deprivations of fundamental rights deny substantive due process and are unconstitutional. *Garcia*, 817 F.2d at 658.

[78] *Garcia*, 817 F.2d at 658.

[79] *See supra* note 36.

who have been subjected to severely abusive corporal punishment.[80] Both courts and commentators have indicated that an individual's interest in freedom from bodily intrusions is a fundamental interest which should be afforded the strictest of scrutiny.[81] While the argument may still exist that the state has a legitimate, and perhaps compelling, interest in maintaining classroom order, it has been suggested that severe physical punishment rarely, if ever, serves the state's interest and that such order could be accomplished by less restrictive means.[82] Even the Fifth Circuit in *Woodard* implied that at some point the *Ingraham* decision, which rejected a substantive due process claim, may need to be reevaluated.[83] Thus, the decision in *Garcia* is clearly consistent with the apparent trend toward providing substantive due process protection from excessive punishment. Although the court, which relied largely on the *Hall* test, could have provided clearer standards or guidelines for determining whether instances of corporal punishment violate substantive due process, *Garcia*, in conjunction with *Hall*, clears the way for the Supreme Court to declare excessive corporal punishment of school children a violation of substantive due process.

Rob Rhea

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[80] *See supra* notes 39-53 and accompanying text.
[81] *See supra* note 42.
[82] *See supra* note 33.
[83] *See supra* notes 68-69.

Constitutional Law — Affirmative Action — Court-Ordered One-Black-For-One-White Promotional Quota Constitutional if Narrowly Tailored to Serve Compelling Governmental Interest

Plaintiffs[1] sought an order in the United States District Court for the Middle District of Alabama to enforce previous consent decrees[2] through institution of a fifty percent promotional quota for new state trooper corporals until defendants[3] developed a valid promotional scheme which did not have an adverse impact on blacks.[4] Plaintiffs contended the quota would alleviate the underrepresentation of blacks in the Alabama Department of Public Safety's upper ranks.[5] Defend-

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[1] Plaintiffs were the National Association for the Advancement of Colored People (NAACP), the United States, and Phillip Paradise, Jr., intervening on behalf of a class of black plaintiffs. United States v. Paradise, 107 S. Ct. 1053, 1058 (1987).

[2] *Id.* at 1058. The action originated in 1972 when the NAACP challenged the long-standing discriminatory hiring practices of the Alabama Department of Public Safety. NAACP v. Allen, 340 F. Supp. 703, 704 (N.D. Ala. 1972). Paradise was a plaintiff in the original action, although his name was not reflected in the case name. *Id.* at 703-04. The United States was joined as party plaintiff. *Id.* at 708 n.3. Other published opinions developing the procedural history of this case are: Paradise v. Prescott, 585 F. Supp. 72 (M.D. Ala. 1983); Paradise v. Prescott, 580 F. Supp. 171 (M.D. Ala. 1983); Paradise v. Shoemaker, 470 F. Supp. 439 (M.D. Ala. 1979); NAACP v. Dothard, 373 F. Supp. 504 (M.D. Ala. 1974); NAACP v. Allen, 340 F. Supp. 703 (M.D. Ala. 1972) *aff'd* 493 F.2d 614 (5th Cir. 1974). Following the 1972 determination that the Alabama Department of Public Safety had engaged in blatant and continuous hiring discrimination, the district court issued an order requiring the department to employ one black trooper for each white trooper hired until blacks comprised approximately 25 percent of the state trooper force. *Allen*, 340 F. Supp. at 706. Additionally, the court enjoined further discriminatory employment practices, including promotions. *Id.* In a 1979 consent decree, the department agreed to develop within the year a fair promotional procedure lacking adverse impact on blacks. *Prescott*, 580 F. Supp. at 172. In 1981, the court approved a second consent decree in which the department reaffirmed its commitment. *Id.* at 172-73.

[3] *Paradise*, 107 S. Ct. at 1058. The defendant on appeal was the United States. *Id.* The Alabama Department of Public Safety and its director, defendants at the district court level, filed briefs in support of the United States, but did not petition for certiorari. *Id.* at 1058 n.1. The United States agreed the consent decrees should be enforced but opposed the 50 percent promotional quota. *Id.* at 1061.

[4] *Id.* In his 1972 opinion, District Judge Frank M. Johnson, Jr., noted that the Alabama Department of Public Safety had egregiously discriminated against blacks since its formation. *Id.* at 1058. In the 37-year existence of the patrol, the department had not hired a single black trooper. *Id.*

[5] *Id.* at 1061.

ant opposed the quota as violative of the equal protection guarantee of the fourteenth amendment.[6] The federal district court granted plaintiffs' motion to institute the promotional quota.[7] The United States Court of Appeals for the Eleventh Circuit affirmed.[8] On writ of certiorari, the United States Supreme Court, *held*, affirmed.[9] Where there exists a compelling governmental interest in alleviating employment discrimination in light of a long history of resistance and delay in remedial action, and where the relief indicated is narrowly tailored to serve legitimate governmental purposes, the equal protection clause permits a federal district court to fashion a remedial decree in the form of a one-black-for-one-white promotional quota. *United States v. Paradise*, 107 S. Ct. 1053 (1987).

The equal protection clause of the fourteenth amendment[10] has been interpreted to protect individuals from burdensome governmental classifications.[11] The United States Supreme Court has traditionally approached classifications which burden minorities with suspicion,[12]

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[6] *Id.* at 1064 n.16.

[7] *Id.* at 1063. The court imposed the 50 percent promotional quota in the upper ranks of the department, but stated that its imposition would be contingent on the availability of qualified black candidates, the rank being less than 25 percent black, and whether or not the department had developed a valid promotion plan which did not adversely impact on blacks. *Id.* The court dismissed the department's proposal to promote 15 candidates to corporal, four of whom would be black, and denied the request for more time to develop a promotional procedure in conjunction with the Department of Personnel. *Id.* at 1062.

[8] Paradise v. Prescott, 767 F.2d 1514, 1537-38 (11th Cir. 1985). The court stated the relief was necessary to remedy the present effects of past discrimination. *Id.* at 1538.

[9] *Paradise*, 107 S. Ct. at 1064.

[10] U.S. CONST. amend. XIV, § 1. "No state shall . . . deny to any person within its jurisdiction the equal protection of the laws." *Id.* The fifth amendment due process clause has been interpreted to incorporate the equal protection guarantee as applicable to federal government actions. *See* Bolling v. Sharpe, 347 U.S. 497, 499 (1954)(District of Columbia school segregation violated fifth amendment due process clause). *See also* Washington v. Davis, 426 U.S. 229, 239-42 (1976)(disproportionate racially discriminatory impact of government act alone not sufficient to constitute violation of equal protection); Weinberger v. Wiesenfeld, 420 U.S. 636, 638 n.2 (1975)(denial of widower's Social Security survival benefits violated fifth amendment equal protection).

[11] J. NOWAK, R. ROTUNDA & J. YOUNG, CONSTITUTIONAL LAW, § 16-1, at 585 (2d. ed. 1983)[hereinafter NOWAK]. In recent years, the equal protection clause has become the most important constitutional vehicle to protect individual rights. *Id.*

[12] *Id.* § 16-1, at 591. In United States v. Carolene Products, 304 U.S. 144 (1938), Justice Stone in his famous footnote 4 indicated that a more stringent standard of review should apply to "discrete and insular minorities" including particular religious, national or racial groups. *Id.* at 152-53 n.4.

viewing such classifications[13] as calling for a more searching judicial inquiry.[14] However, the Court has not yet resolved the extent to which a classification might be employed to benefit a minority, nor has it determined the appropriate level of judicial inquiry to review such a classification.[15]

The Supreme Court first encountered the constitutionality of a race-conscious remedial measure to repair denial of a constitutional right in the context of school desegregation.[16] Responding to the 1954

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[13] NOWAK, *supra* note 11, § 16-1, at 587. The concept of equal protection tests whether a classification is properly drawn when it distinguishes people as dissimilar to advance a legitimate interest of society. *Id.* § 16-1, at 586-87. The equal protection clause does not operate to deny the government's ability to "draw lines", but it does guarantee that the classification will not use impermissible criteria or arbitrarily burden a group of individuals. *Id.* § 16-1, at 586.

[14] *Id.* § 16-1, at 591. The Supreme Court has employed three levels of equal protection analysis. *See* Plyer v. Doe, 457 U.S. 202, 216-17 (1982)(levels of scrutiny depend upon classification); San Antonio Indep. School Dist. v. Rodriguez, 411 U.S. 1, 28 (1973)(politically powerless minority needs extraordinary protection from majoritarian political process). The rational relationship test is generally employed in the area of economic legislation. *See* Note, *Constitutional Law: Activating the Middle Tier After Plyler v. Doe: Cleburne Living Center v. City of Cleburne*, 38 OKLA. L. REV. 145, 146-48 (1985)(review of three tier analysis under equal protection clause). The Court merely determines whether a classification bears a rational relationship to a constitutionally permissible governmental end. *Id. See, e.g.*, Williamson v. Lee Optical Co., 348 U.S. 483, 491 (1955)(classification of opticians rationally related to legitimate governmental interest). In classifications involving gender, illegitimacy, or alienage, the Court considers whether a classification is substantially related to an important governmental objective. *See, e.g.*, *Plyer*, 457 U.S. at 216 (statute not valid unless it furthers substantial state goal); Trimble v. Gordon, 430 U.S. 762, 767 (1977)(classifications based on illegitimacy not subject to strict scrutiny); Craig v. Boren, 429 U.S. 190, 197 (1979) (intermediate test used to strike gender-based classifications); Matthews v. Lucas, 427 U.S. 495, 510 (1976)(statutory classification justified as reasonable empirical judgment which does not broadly discriminate between legitimates and illigitimates). The Supreme Court has established strict scrutiny as the proper standard of review when a classification involves a fundamental right or a suspect classification, such as race or national origin. *See* Loving v. Virginia, 388 U.S. 1, 12 (1967)(statute proscribing interracial marriage violates equal protection); Hernandez v. Texas, 347 U.S. 475, 481-82 (1954)(exclusion from jury service based on person's national origin prohibited by fourteenth amendment); Skinner v. Oklahoma, 316 U.S. 535, 541 (1942)(fundamental right to procreation). Under strict scrutiny review, the government must demonstrate there is a compelling governmental interest and that the means contemplated is absolutely necessary to achieve the interest. NOWAK, *supra* note 11, § 16-1, at 593-94. *See, e.g.*, Korematsu v. United States, 323 U.S. 214, 223 (1944)(government-imposed injury on Japanese-Americans justifiable under strict scrutiny where governmental interest was national security).

[15] Stewart, *Affirmative Action Barely Upheld*, 72 A.B.A. J. 44, 106 (1986).

[16] In Brown v. Board of Education, 347 U.S. 483 (1954), the Court held that public school segregation was a violation of the equal protection guarantee. *Id.* at 495. The Su-

school desegregation mandate,[17] the Court in *Brown v. Board of Education (Brown II)*[18] addressed the proper remedy for government-imposed segregation, determining that the district court should assume the responsibility[19] of assuring good faith[20] implementation of policies by local school authorities.[21] The *Brown II* Court stated that the district court should be guided by equitable principles in fashioning a remedy to effectuate plaintiffs' prompt entry into the public school system.[22] The Court further clarified the scope of a district court's re-

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preme Court overruled the "separate but equal" doctrine espoused in Plessy v. Ferguson, 163 U.S. 537 (1896), concluding that the doctrine had no place in the field of public education. *Brown*, 347 U.S. at 495. The Court reasoned that separation of children from others of similar age on the basis of race generated such feelings of inferiority that the effect on the children might never be undone. *Id.* at 494. *See generally* McLaurin v. Oklahoma State Regents, 339 U.S. 637, 642 (1949)(precluded differential treatment of black man in state-supported graduate school); Missouri *ex rel.* Sweat v. Painter, 339 U.S. 629, 635-36 (1949)(segregated law school did not provide equal educational opportunities for blacks because of intangible qualities); Gaines v. Canada, 305 U.S. 337, 345 (1938)(Missouri's action in providing in-state law school education for whites but not for blacks violated equal protection). In addressing the matter of what relief should be accorded those students who were denied equal protection in public schools, the Court approved the use of racial classifications to achieve school desegregation which in some instances could be mandated by a district court order. NOWAK, *supra* note 11, § 16-2, at 662. *See generally* Fiss, *One Century of Anti-Discrimination*, 15 CAP. U.L. REV. 395, 396-98 (1986)(discussion of history of affirmative action).

[17] *See supra* note 16.

[18] 349 U.S. 294 (1955).

[19] *Id.* at 299. The goal was the transition from a segregated public education system to one that was free from racial discrimination. *Id.* at 298.

[20] *Id.* at 299. The Supreme Court stated that good faith compliance with the court order would be met by making a prompt, reasonable start in desegregation of the schools, giving consideration to public and private concerns, but complying fully at the earliest possible date. *Id.* at 300.

[21] *Id.* at 299. The Court conceded that while school officials have primary responsibility of assessment and resolution of problems, the district court should make the determination whether the authorities were acting in good faith, based upon its awareness of local conditions and ability to best perform the judicial appraisal. *Id.*

[22] *Id.* at 300. The Court commented that equity is characterized by flexibility in formulating remedies and the ability to reconcile public and private needs. *Id.* In developing a non-racial admission system, the *Brown II* Court noted that the district court would encounter several problems including the school transportation system, personnel, and revision of local laws. *Id.* at 300-01. The district court was to retain jurisdiction during the transition period. *Id. See also* Hecht v. Bowles, 321 U.S. 321, 329-30 (1935)(court can reconcile public and private needs); Alexander v. Hillmann, 296 U.S. 222, 239 (1935)(court of equity has flexibility in fashioning remedies). *See generally* Bickel, *The Decade of School Desegregation: Progress and Prospects*, 64 COLUM. L. REV. 193, 212-18 (1964)(summary of problems encountered by local school districts in attempts to comply with desegregation mandates), Bickel, *The Original Understanding of*

medial powers in *Swann v. Charlotte-Mecklenburg Board of Education*.[23] In *Swann*, the Supreme Court addressed a North Carolina local school system's failure to remedy intentional discrimination.[24] The challenged desegregation plan,[25] fashioned by the district court, employed a black-to-white ratio to achieve non-discriminatory pupil assignments.[26] Emphasizing the broad power of a district court in remedying *de jure* segregation,[27] the *Swann* Court upheld the use of such a ratio as a useful starting point to eradicate the effects of past discrimination.[28] The Court concluded that the remedy employed by the district court was reasonable, feasible, and workable.[29]

In an effort to remedy the inequalities caused by past discrimina-

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the Segregation Decision, 69 HARV. L. REV. 1, 60-65 (1955)(discussion of ramifications of desegregation); Black, *The Lawfulness of the Segregation Decisions*, 69 YALE L. J. 421, 425-30 (1960)(discussion of segregation's function to keep blacks in an inferior position); McKay, *With All Deliberate Speed: A Study of School Desegregation Decisions*, 31 N.Y.U. L. REV. 991, 1016-66 (1956)(review of methods used by southern states to avoid school desegregation).

[23] 402 U.S. 1 (1971).

[24] *Id.* at 7-8. The school system had failed to develop and implement an effective desegregation plan following a district court order. *Id.*

[25] *Id.* at 10. A court-appointed expert, in conjunction with the school board, submitted the challenged plan which was subsequently adopted by the district court. *Id.*

[26] *Id.* The plan employed racial quotas, rezoning, and busing to remedy state-enforced segregation. *Id.* at 20.

[27] *Id.* at 31. *De jure* segregation is defined as government-imposed separation of students solely on the basis of race. *Id.* at 6.

[28] *Id.*

[29] *Id.* The Supreme Court has approved other reasonable race-conscious remedial measures fashioned by district courts. *See, e.g.*, United Jewish Orgs. v. Carey, 430 U.S. 144, 168 (1977)(upheld plan re-apportioning New York City counties in compliance with Voting Rights Act to favor election of non-whites); Louisiana v. United States, 380 U.S. 145, 154 (1974)(affirmed district court's duty to render decree to eliminate discriminatory effects). *See generally* Bd. of Educ. v. Swann, 402 U.S. 43, 46 (1970)(Court held race can be considered in remedy of constitutioanl violations); United States v. Montgomery County Bd. of Educ., 395 U.S. 225, 236-37 (1969)(black-to-white faculty goal upheld); Green v. County School Bd., 391 U.S. 430, 441-42 (1967)(freedom-of-choice plans to effect school desegregation rejected in favor of affirmative measures to bring about unitary school system); Abram, *Affirmative Action; Fair Shakers and Social Engineers*, 99 HARV. L. REV. 1312, 1317-26 (1986)(discussion of effects of "color-blindness" on civil rights in America); Ely, *The Constitutionality of Reverse Discrimination*, 41 U. CHI. L. REV. 723, 735-36 (1974)(discussion that reverse discrimination was constitutional because white majority was choosing to discriminate against itself); Fiss, *The Charlotte-Mecklenburg Case; Its Significance for Northern School Desegregation*, 38 U. CHI. L. REV. 697, 699-03 (1971)(discussion of *Swann's* four doctrinal advances to remedy discrimination); Richter, *School Desegregation After Swann: A Theory of Government Responsibility*, 39 U. CHI. L. REV. 421, 442-47 (1972)(reviews potential costs to school systems of remedial court orders).

tion, both public and private institutions developed affirmative action programs which conferred preferential treatment on blacks and other minorities.[30] The Supreme Court first dealt with the legality of a preferential racial classification in the context of higher education admission programs.[31] In *Regents of the University of California v. Bakke*,[32] the Supreme Court confronted a constitutional challenge to a special admissions program developed to increase minority enrollment at the medical school of the University of California at Davis.[33] Bakke, a white applicant denied admission despite having scored higher on the admission criteria than some minority applicants that had been accepted,[34] challenged the plan as a violation of equal protection and the Civil Rights Act of 1964.[35] Even though unable to agree on a standard of judicial review,[36] the Court found that, although a university might give favorable weight to minority status as part of a plan to diversify

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[30] *See* Fallon, *A Constructivist Coherence Theory of Constitutional Interpretation*, 100 HARV. L. REV. 1189, 1270 (1987)(analyzing different types of affirmative action programs).

[31] NOWAK, *supra* note 11, § 16-1, at 666. In Defunis v. Odegaard, 416 U.S. 312 (1974), the Court failed to reach the merits in a challenge to a special minority admissions program. *Id.* at 319-320. In *Defunis*, a white applicant to the University of Washington Law School claimed he was rejected because the admissions procedures invidiously discriminated against him, violating his equal protection guarantee. *Id.* at 314. The Court ruled the case moot due to the petitioner's imminent law school graduation. *Id.* at 319-20. Justice Douglas, in a dissenting opinion, argued that the Court should have reached the merits of the case, and noted that it might be appropriate to give some preference to minorities who were residents of the state. *Id.* at 347.

[32] 438 U.S. 265 (1978).

[33] *Id.* at 272. The special admissions program set aside 16 of 100 slots for minority applicants as part of a plan to increase minority enrollment. *Id.* The program operated in conjunction with the regular admissions program. *Id.* at 273-74. The admissions committee was composed primarily of minorities. *Id.* No disadvantaged whites achieved admission through the program. *Id.* at 276.

[34] *Id.* at 277 n.7. In 1973, Bakke's GPA was 3.46 while the average of a special admittee was 2.88. *Id.* Bakke's MCAT scores were also significantly higher. *Id.*

[35] *Id.* at 272. Title VI of the Civil Rights Act of 1964 provides that no person "shall on the ground of race or color be excluded from participating in any program receiving federal financial assistance." Civil Rights Act of 1964, § 601, 42 U.S.C. § 2000d (1982).

[36] *Id.* at 290-91 and 361-62. The members of the *Bakke* Court authored six separate opinions. *Id.* at 287. Justice Powell delivered the judgment of the Court in his separate opinion. Because the plan involved a racial classification, Justice Powell argued that strict scrutiny should be utilized. *Id.* at 291. Concurring in the impermissibility of the Davis program, Justices Burger, Rehnquist, Stewart and Stevens, basing their conclusion on Title VI rather than on constitutional grounds, argued for a standard of review more stringent than strict scrutiny. *Id.* at 416. Justices Brennan, White, Marshall and Blackmun, in contrast to Justice Powell, maintained that the standard of review applied to benign racial classifications should be an intermediate one. *Id.* at 359; *see infra* note 40.

the student body,[37] a rigid quota based on race was unconstitutional.[38] In announcing the judgment of the Court, Justice Powell expressed the view that any racial classification should be subjected to strict scrutiny[39] to determine its legality.[40] As such, Justice Powell indicated that the preferential admissions plan should be upheld only if its objectives were permissible and substantial, and the means to achieve it were necessary.[41] Expressing concern that innocent white applicants should not bear the burden of redressing past discrimination by others,[42] the *Bakke* Court concluded that the admissions program was unlawful under Title VI, and ordered Bakke to be admitted to the medical school.[43]

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[37] *Id.* at 287. The *Bakke* Court concluded that the state had a substantial interest which might be legitimately served by the consideration of race or ethnic origin to obtain a diverse student body. *Id.* Justice Powell described the Harvard admissions program as one in which race was only one of the factors considered in the admission process, with the goal being that of achieving diversity within the student population. *Id.* at 314-15.

[38] *Id.* at 319. Justice Powell, whose opinion was significant since the case turned on his vote, deemed that the fatal flaw of the program was its disregard of individual rights. *Id.* at 271-72 and 319. Justices Brennan, White, Marshall, and Blackmun contended the admissions plan violated neither Title VI nor the fourteenth amendment. *Id.* at 325. Chief Justice Burger and Justices Stevens, Stewart, and Rehnquist stated that the program violated Title VI and did not reach the constitutional issue. *Id.* at 421. Justice Powell expressed displeasure with the plan because non-minority students were excluded from specific seats in the entering class, regardless of their qualifications. *Id.* at 319-20. Minority applicants, however, could compete for every seat in the entering class. *Id.* See *generally* Blumrosen, *Affirmative Action in Employment after Weber*, 34 RUTGERS L. REV. 1, 39-41 (1981)(discussion of quota relief in affirmative action plans).

[39] *Bakke*, 438 U.S. at 291. Justice Powell pronounced that racial and ethnic classifications were inherently suspect. *Id.* To justify the classification, the state must prove that a compelling purpose existed and that its use was necessary to accomplish the purpose. *Id.* at 305. *See* Hirabayashi v. United States, 320 U.S. 81, 100 (1943)(distinctions between persons on basis of ancestry were odious in society founded on equality).

[40] *Bakke*, 438 U.S. at 291. Justice Powell concluded that any racial or ethnic classification was inherently suspect, calling for the "most exacting judicial examination." *Id.* Justice Powell stated that a preferential treatment might not always be benign; burdens might be imposed on one group to advance another group's general interests. *Id.* at 298. Moreover, Justice Powell noted that preferential treatment might perpetuate stereotypes that certain groups could not succeed without protection. *Id.*

[41] *Id.* at 305.

[42] *Id.* at 298. The *Bakke* Court stated that societal discrimination did not justify a classification which disadvantaged others. *Id.* at 310.

[43] *Id.* at 325. Justice Brennan, joined by Justices White, Marshall, and Blackmun, rejected the notion that remedying past societal discrimination could not justify such a plan. *Id.* at 362 (Brennan, White, Marshall, and Blackmun, J.J., concurring in part and dissenting in part). The plan was constitutional, according to Justice Brennan, since it served an important governmental objective and was substantially related to the achievement of the objective. *Id.* at 359. *See generally* Bell, *Bakke, Minority Admissions and*

The next constitutional challenge to affirmative action brought before the Court was in *Fullilove v. Klutznick*.[44] In *Fullilove*, the Supreme Court sustained a congressionally imposed plan which required that ten percent of federal funds allocated for public works be used, absent an administrative waiver, to purchase goods or services from minority business enterprises.[45] The Court recognized that the minority set-aside, as applied to private contractors, was within the constitutional authority of Congress under the commerce power[46] and the spending power,[47] and the means chosen were necessary for accomplishing the objective.[48] In determining whether the set-aside was within congressional authority under the fourteenth amendment, the *Fullilove* Court applied a two-pronged analysis.[49] Recognizing that Congress had abundant authority to conclude minorities had been denied participation in governmental contracting opportunities, the

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the Usual Price of Racial Remedies, 67 CALIF. L. REV. 1, 17-19 (1979)(discussion of uncertain future use of racial remedies in light of *Bakke*).

[44] 448 U.S. 448 (1980).

[45] *Id.* at 453. The challenge involved the "minority business enterprise" provision of the Public Works Employment Act of 1977, 52 U.S.C. § 6705(f)(2)(Supp. 1979), which specified that 10 percent of four billion dollars in federal money was to be allocated to business enterprises owned by United States citizens who were Negroes, Spanish-speaking, Orientals, and other identified minority groups. *Id.* at 454.

[46] *Fullilove*, 448 U.S. at 475. The Court stated that Congress could enact the legislation under its commerce power delegated in article I, section eight, clause three of the Constitution. *Id.* The *Fullilove* Court found that Congress had a reasonable basis to conclude that the contracting inequities had an effect on interstate commerce, thus justifying the legislation. *Id.*

[47] *Id.* at 473. The Court held that in enacting the provision, Congress was clearly acting within the spending power delegated to the legislature in article I, section eight, clause one. *Id.* Additionally, the Court noted that Congress had often acted under the spending power to further policy objectives by making receipt of federal funds conditional upon compliance with federal statutes. *Id.* at 474. *See, e.g.*, California Bankers Ass'n v. Schultz, 416 U.S. 21, 42-43 (1974)(record-keeping requirements imposed by Bank Secrecy Act not violative of due process); Oklahoma v. United States Civil Serv. Comm'n, 330 U.S. 127, 144 (1947)(under Hatch Act imposition of conditions on grant of funds to prevent improper political activities was question of administrative discretion); Helvering v. Davis, 301 U.S. 619, 640 (1937)(Congress' power to spend in aid of the "general welfare" validated income tax levied on employees and excise tax levied on employers by Social Security Act).

[48] *Fullilove*, 448 U.S. at 473-76. The Court found the means to be necessary since the legislation was the least burdensome solution for increasing minority participation in the construction industry. *Id.*

[49] *Id.* at 473. The Court stated that it must determine, first, whether the legislative objectives were within congressional power, and second, whether the racial criteria invoked was a permissible means for achieving these objectives. *Id.*

Court found that a valid legislative objective[50] in remedying the effects of past discrimination existed.[51] Stressing the limited scope of judicial inquiry into congressional remedial authority, the Court held that some use of racial and ethnic criteria was a constitutionally permissible means to achieve the governmental objective[52] as long as there were provisions for exemption and waiver.[53] The Court rejected the contention that Congress must act in a "color-blind" manner when fashioning a remedy, emphasizing that no branch of government had more comprehensive remedial power nor greater authority to enforce equal protection guarantees.[54]

The Court has regularly rejected Title VII objections to affirmative action plans.[55] However, in *Firefighters Local Union No. 1984 v.*

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[50] *Id.* at 478. The valid legislative objective at issue was the elimination of discrimination in governmental contracting. *Id.*

[51] *Id.* The Court noted that it was not necessary for Congress to compile a record of discrimination to the extent appropriate for judicial and administrative findings. *Id.*

[52] *Id.* at 480. The Court rejected the idea that Congress should become "color-blind" when acting in a remedial context. *Id.* at 482-84.

[53] *Id.* at 486-89. The waiver and exemption provisions as well as administrative safeguards provided assurance that use of racial criteria would be limited to achieve the objectives in the event there were insufficient minority bids. *Id.*

[54] *Id.* at 482-83. The *Fullilove* Court emphasized it was not dealing with the limited remedial powers of a district court, but rather with the broad congressional powers expressly granted in the Constitution. *Id.* Justice Marshall, joined by Justices Brennan and Blackmun in a concurring opinion, relied on an intermediate standard of review. *Id.* Justice Marshall wrote that the racial classification employed to remedy past discrimination was constitutional since it served important and congressionally articulated goals and was substantially related to the achievement of the goals. *Id.* at 519. Justice Powell, in a concurring opinion, applied the analysis which he initially set forth in *Bakke*. *Id.* at 496 (Powell, J., concurring). Justice Powell reasoned that the remedy served a compelling governmental interest since Congress had demonstrated findings of unlawful discrimination. *Id.* He found the means were narrowly drawn to fulfill the purpose, reviewing several factors which had been considered by district courts in their formulation of remedies: efficacy of alternative remedies, planned duration of the remedy, the relationship between the percentage of minorities to be employed and the percentage of minorities in the workforce, the availability of a waiver, and the effect on innocent third parties. *Id.* at 510-15. *See generally* Days, *Fullilove*, 96 YALE L. J. 453, 465-78 (1987)(describes constitutional analysis in *Fullilove* and developments in use of minority set-asides for remedial purposes; Bohrer, *Bakke, Weber and Fullilove: Benign Discrimination and Congressional Power to Enforce the Fourteenth Amendment*, 56 IND. L. J. 473, 505-11 (1981)(comparison of Supreme Court affirmative action decisions under Title VII and fourteenth amendment).

[55] In United Steel Workers v. Weber, 443 U.S. 193 (1979), the Supreme Court first entertained a Title VII challenge to a voluntary affirmative action program. *Id.* at 208. In *Weber*, the union had entered into a collective bargaining agreement with Kaiser Aluminum to eliminate racial imbalances in a skilled craft training program by reserving 50

Stotts,[56] the Supreme Court sustained a Title VII challenge to an affirmative action plan,[57] ruling that the district court had exceeded its remedial authority where there had been no finding of discrimination.[58] In response to a class action suit[59] alleging racially discriminatory employment practices[60] in the Memphis, Tennessee Fire Department, the parties entered a consent decree for remedial purposes.[61] When budgetary deficits required layoffs,[62] the federal district court issued an injunction requiring white employees to be laid off ahead of black employees with less seniority.[63] The *Stotts* Court, finding that the

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percent of the openings for black craftworkers until the number of workers was commensurate with the percentage of blacks in the local labor force. *Id.* at 198-99. The plan resulted in favoring black production workers over white production workers with more seniority for entry into the training. *Id.* at 199. Weber, a white production worker, challenged the plan as a violation of Title VII's prohibition against discriminatory employment practices. *Id.* at 200. In deciding *Weber*, the Court referred to the legislative history and inferred Congress did not intend to prohibit voluntary steps by private employers, but did not require them. *Id.* at 207. The plan served a purpose in breaking down patterns of discrimination in areas traditionally segregated, was temporary, and it did not trammel the interests of whites by acting as a bar to advancement. *Id.* at 208. In Johnson v. Transportation Agency, Santa Clara County, 107 S.Ct. 1442 (1987), the Court extended the *Weber* decision in upholding under Title VII, for the first time, a voluntary affirmative action plan authorizing gender as one factor to be considered in job categories in which women were traditionally underrepresented. *Id.* at 1456-57. The Court stated that the employment decisions should not be justified solely by reference to the racial or gender imbalance, but should rely on a multitude of realistic, practical factors. *Id.*

[56] 467 U.S. 561 (1984).

[57] *Id.* at 567. The challenge involved Title VII of the Civil Rights Act of 1964, 42 U.S.C. § 2000e (1982). *Stotts*, 467 U.S. at 565.

[58] *Stotts*, 467 U.S. at 583. The Supreme Court noted the primary issue in the case was whether the district court had exceeded its equitable powers in issuing an injunction requiring the layoff of white employees, when a bonafide seniority system would call for the layoff of blacks. *Id.* at 572-73.

[59] *Id.* at 565. After certifying the case as a class action, the district court consolidated it with an individual suit filed by Fred Jones, a private in the fire department, who alleged he had been denied promotion due to his race. *Id.*

[60] *Id.* Stotts alleged the department and some city officials were engaged in a practice or pattern of racially discriminatory hiring and promotion decisions. *Id.*

[61] *Id.* at 566. After settlement negotiations, the consent decree was voluntarily entered to remedy discriminatory hiring and promotion practices. *Id.* The department adopted a long-term goal of increasing minority representation in every job classification to approximate the proportion of blacks in the local labor force. *Id.*

[62] *Id.* Layoffs were to be determined under the "last-hired, first-fired" rule based on city-wide seniority, pursuant to a seniority system mentioned in the consent decree. *Id.*

[63] *Id.* at 567. The district court concluded that the proposed layoffs would have a discriminatory effect, and that the seniority system was not bona fide and should not be applied. *Id.* Layoffs of white employees were carried out, in compliance with the injunction. *Id.*

protected black employees had not ever been discriminated against,[64] and that in keeping with Title VII[65] competitive seniority should be awarded only to actual victims of illegal discrimination,[66] concluded that the district court had exceeded its equitable powers.[67]

In 1986, the Court again addressed the legality of a layoff plan, sustaining an equal protection challenge in *Wygant v. Jackson Board of Education*.[68] In *Wygant*, the Jackson, Michigan Board of Education responded to racial tension in the community through voluntary implementation of a plan to employ minority teachers.[69] Faced with budgetary constraints, the school board laid off white teachers with more seniority ahead of black teachers recently hired.[70] The *Wygant* Court held that the layoff provision violated the equal protection clause.[71] In applying the two-pronged analysis,[72] the Court noted that the level of scrutiny did not change merely because it operated against a group that historically had not been subject to discrimination.[73] Since societal discrimination alone was not sufficient to justify a racial classifica-

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[64] *Id.* at 579. The Court stated that mere membership in a minority is not sufficient to warrant an award of seniority. *Id.*

[65] *Id.* The Court viewed the district court ruling as undermining the policy of Title VII, which granted make-whole relief only to actual victims of discrimination. *Id.* at 580.

[66] *Id.* If the individual members of the plaintiff class showed they were actual victims of discrimination, the *Stotts* Court indicated they might be awarded competitive seniority. *Id.*

[67] *Id.* at 583. *See generally* Williams, *Last Hired, First Fired—Rights without Remedies: Firefighters v. Stotts*, 1985 DET. C.L. REV. 215, 239-45 (argued Supreme Court proceeded improperly as though there had been trial on city's discriminatory practices); Sullivan, *The Clarification of Firefighters v. Stotts*, 37 LAB. L.J. 788, 789-99 (1986)(arguing subsequent court affirmative action decisions diminished importance of *Stotts*).

[68] 106 S. Ct. 1842 (1986).

[69] *Id.* at 1844-45. The plan provided that if it became necessary to reduce the number of teachers, those with the most seniority should be retained, but the percentage of minorities to be laid off should at no time exceed the percentage of minorities employed at the time of the layoff. *Id.*

[70] *Id.* at 1845. Wendy Wygant, one of the white teachers laid off, challenged the plan. *Id.* at 1846.

[71] *Id.* at 1852. In reversing the decision of the United States Court of Appeals for the Sixth Circuit, the *Wygant* Court found that the layoff plan was not "sufficiently narrowly tailored." *Id.* The Court indicated, however, that where identified victims of individual discrimination existed, the Court might award competitive seniority. *Id.* at 1852 n.12.

[72] *Id.* at 1846. The Court noted that any racial preference must be justified by a compelling governmental interest. *Id.* Secondly, the remedy should be narrowly tailored to the achievement of the interest. *Id.*

[73] *Id.*

tion,[74] and since the state's interest in providing role models for minorities did not justify burdening the innocent,[75] the Court concluded there was no compelling governmental interest to justify the layoff.[76] Additionally, the Court reasoned that since layoff plans imposed a heavy burden on whites and other less intrusive means were available, the plan was not narrowly tailored.[77] The Court emphasized that the ultimate burden was on employees to demonstrate the unconstitutionality of an affirmative action plan and that in this instance the burden had been met.[78]

Six weeks following the *Wygant* decision, the Supreme Court handed down its opinion in *Local 28 of the Sheet Metal Workers v. EEOC*.[79] In *Sheet Metal Workers*, the Court upheld a race-conscious union membership goal[80] imposed by a federal district court, rejecting

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[74] *Id.* at 1847. The Court stated that societal interest alone was too amorphous to justify a race-conscious remedy. *Id.* at 1848. The *Wygant* Court recognized that, admittedly, there had been societal discrimination in this country, but to base the imposition of legal remedies that burden innocent people on such societal discrimination was overexpansive and insufficient. *Id.* The Court contrasted the layoff program with a preferential hiring program that would reduce the burden upon society. *Id. See* Hazlewood School Dist. v. United States, 433 U.S. 299, 312-13 (1977)(illustrations of Court's insistence on showing of prior discrimination by governmental body to justify adoption of race-conscious remedy).

[75] *Wygant*, 106 S. Ct. at 1848. The Court said that the "role model" theory typified indefiniteness. *Id.* Carrying the theory to its logical extreme would result in the idea that black students were better off with black teachers, perpetuating the very system rejected in *Brown*. *Id.* Therefore, the Court found that the "role model" theory was insufficient since under the theory a court could justify remedies "ageless in their reach into the past, and timeless in their ability to affect the future." *Id.*

[76] *Id.* at 1847. The Court feared the "role model" theory would allow discriminatory hiring and layoffs long past the point required for a remedial purpose. *Id.* Thus, the Court held that a public employer should have convincing evidence of discrimination before employing an affirmative action program. *Id.*

[77] *Id.* at 1851-52. The Court noted that hiring goals diffused individual burdens to be dispersed among society and that even a temporary layoff would have adverse psychological and financial effects. *Id.*

[78] *Id.* at 1848. Justice Marshall, joined by Justices Brennan and Blackmun, asserted in dissent that no decision should have been rendered because the record was incomplete as to the school's past discrimination. *Id.* at 1858 (Marshall, J. dissenting). Contending that the layoff plan was the narrowest means to preserve the goal of minority representation, Justice Marshall proposed that the district court be allowed to develop the record so the constitutional issue could be resolved. *Id.* The dissent further argued that an employer should be able to constitutionally reserve the benefits of an affirmative action hiring plan through a narrowly tailored layoff plan. *Id.*

[79] 106 S. Ct. 3019 (1986).

[80] *Id.* at 3027. The district court entered an order after a finding of bad faith attempts to avoid and delay affirmative action, concluding the remedial goal was necessary.

arguments that the goal exceeded the district court's remedial powers under Title VII of the Civil Rights Act[81] and was a violation of equal protection.[82] The union had been found guilty of egregious discrimination and repeated resistance and delay,[83] necessitating a district court order to achieve a non-white membership goal of twenty-nine percent[84] and to establish a fund to recruit minorities.[85] The Court rejected the union's argument that Title VII prohibited a court from ordering race-conscious remedies to benefit individuals who were not actual victims of discrimination, reasoning that such a reading of section 706(g) twisted the "plain language of the statute."[86] Justice Brennan, writing for the plurality, indicated that although the Court had not yet agreed on the proper analysis for a race-conscious remedial measure, resolution was unnecessary as the relief ordered exceeded the "most rigorous" test.[87] Since the district court and the court of appeals had found repeated violations of Title VII and resistance to ending such practices, the Courts' affirmative measures were narrowly tailored to further an

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Id.

[81] 42 U.S.C. § 2000e-5(g) (1982). The Court rejected the proposition that § 706(g) prohibited a district court from ordering affirmative race-conscious relief to remedy past discrimination. *Sheet Metal Workers*, 106 S. Ct. at 3034.

[82] *Sheet Metal Workers*, 106 S. Ct. at 3054.

[83] *Id.* at 3027. The district court found that prior to 1973 no minority had ever obtained union membership through organization of a non-union shop. *Id.* The union had accepted only white transfers from sister locals. *Id.*

[84] *Id.* The 29 percent goal was based on the percentage of minorities in the relevant local pool. *Id.*

[85] *Id.* at 3030. The proposed Employment, Training, Education, and Recruitment Fund was to be used to increase non-white applicants for the apprenticeship program, to create summer employment for minorities, and to provide counseling and tutorial services for minorities. *Id.*

[86] *Id.* at 3034-35. The final sentence of § 706(g) addresses a situation in which a union unlawfully discriminates against a minority, yet, is able to show that refusal of membership is based on other grounds, such as lack of qualification. *Id.* at 3035. In such an instance, the court would be prohibited from ordering admittance. *Id.* However, the Court refused to read § 706(g) as prohibiting the affirmative relief awarded by the district court. *Id.* Instead the Court interpreted § 706(g) as delineating the district court's broad power to order affirmative action. *Id.* Further, the Court reasoned that the legislative history confirmed congressional intent to extend relief beyond actual victims of past discrimination. *Id.* at 3038-39.

[87] *Id.* at 3052-53. The Court had consistently recognized racial classifications as an appropriate remedy for past discrimination, as indicated in *Wygant*, *Fullilove*, *Swann*, and *Bakke*. *Id.* The Court reasoned that the relief might be appropriate when a labor union or employer had egregiously discriminated or when steps were necessary to dissipate the lingering effects of past discrimination. *Id.* at 3034-35.

important governmental interest.[88] Finding that the goal was temporary, did not disadvantage existing members, and was necessary to combat the effects of past discrimination, the Court determined that the remedy would survive the strictest scrutiny.[89]

In the instant case, the Supreme Court again acknowledged that, although there was no agreement on an appropriate analysis, even under strict scrutiny the Constitution permitted the use of a racial classification to remedy unlawful discrimination.[90] The Court found a societal interest in compliance with the judgments of federal courts,[91] particularly in view of the Alabama Department of Public Safety's lack of compliance with previous court orders and continued open and pervasive engagement in discriminatory exclusion of blacks from employment and promotion.[92] Therefore, the district court order served a compelling governmental interest.[93] The Court concluded that the one-white-for-one-black promotional quota was necessary to eliminate discrimination as other alternatives would not serve the court's purpose.[94]

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[88] *Id.* at 3053. The union refused to change membership practices despite state and federal court orders. *Id.* at 3028. The district court had made the finding that such affirmative measures were necessary. *Id.* at 3053.

[89] *Id.* The Court indicated the remedy did not require a layoff, nor did it stand as an absolute bar to white applicants seeking admission. *Id.* at 3052. Justice O'Connor filed a partial dissent, concluding that the affirmative action order was applied as a strict racial quota which the union must attain. *Id.* at 3063. She criticized the plurality's vague guidance as to what differentiates a permissible goal from an impermissible quota. *Id.* at 3060. Justice Rehnquist and Chief Justice Burger maintained in dissent that a district court should not order racial preferences for anyone other than actual victims of discrimination. *Id.* at 3063; *see generally* Sullivan, *Sins of Discrimination: Last Term's Affirmative Action Cases*, 100 HARV. L. REV. 78, 79-85 (1986)(review of Court's focus on past discrimination in *Wygant* as well as *Sheet Metal Workers*).

[90] *Paradise*, 107 S. Ct. at 1064. Justice Brennan announced the judgment of the Court and delivered an opinion, with Justices Marshall, Blackmun, and Powell joining, and Justice Stevens concurring in the judgment. *Id.* at 1057. The plurality conceded as now well-established that a governmental body can employ a racial classification to remedy unlawful discrimination. *Id.* at 1064.

[91] *Id.* Brennan noted that the relief was imposed only after the department failed to live up to its commitments which had been approved by the district court. *Id.*

[92] *Id.* at 1065. The Court rejected the department's argument that no relief was justified in the promotional context because it had only been found guilty of intentional discrimination in hiring, not promotion. *Id.* The Court stated the promotional practices had been a central concern of the district court since the inception of the action in 1972 since the discrimination permeated promotional procedures as well as hiring practices. *Id.* at 1066.

[93] *Id.* at 1065.

[94] *Id.* at 1067. The purposes of the order were to eliminate the effects of the department's pervasive discrimination, to ensure speedy compliance with the 1979 and 1981 consent decrees by compelling the department to develop and implement a promotion

In addition, the quota was flexible, temporary, waivable,[95] and contingent on the department's own conduct.[96] Furthermore, the *Paradise* Court reasoned that such relief was narrowly tailored[97] since it bore a proper relation to the percentage of non-whites in the work force[98] and did not unnecessarily burden white promotion candidates.[99] The Court concluded that, as the quota was instituted only after the considered judgment of the district court and was narrowly tailored to serve a compelling governmental interest, the remedy would survive even strict scrutiny, thereby being constitutional under the equal protection clause of the fourteenth amendment.[100]

In an opinion concurring in the judgment,[101] Justice Stevens reasoned that the pronouncement of guilt against the department due to its egregious discrimination provided the district court with broad remedial authority.[102] Absent evidence of an abuse of discretion in fashioning the remedy, the order by the district court judge was, therefore,

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procedure which did not have an adverse impact on blacks, and to eliminate to the extent possible the effects of the department's delay in producing the procedure. *Id.* The Court rejected a proposed alternative to appoint four blacks to the corporal positions as inadequate to serve all of the district court's purposes. *Id.* The Supreme Court also rejected the government's proposal of imposing heavy fines pending compliance, since the alternative was never proposed to the district court and previous orders to pay plaintiff's attorney's fees had done little to prevent delays. *Id.* at 1069.

[95] *Id.* at 1071. The Court emphasized that the 50 percent quota was not a goal in itself, but was only representative of the speed in which the established goal (25 percent of the department's corporals to be black) would be achieved. *Id.* On achievement of the goal, the quota was to be suspended. *Id.* The goal could be waived if no qualified black candidates were available. *Id.*

[96] *Id.* at 1073. The quota would be suspended when the goal was met. *Id.*

[97] *Id.* at 1074.

[98] *Id.* at 1071. The *Paradise* Court noted that the quota required only that 50 percent black candidates be promoted until 25 percent of the rank was black. *Id.*

[99] *Id.* at 1073. The quota did not require a layoff of white employees and resulted only in postponing the promotions of some qualified whites. *Id.*

[100] *Id.* at 1073-74.

[101] *Id.* at 1075. Justice Powell filed a concurring opinion further elaborating on the five relevant factors to be considered in determining whether an affirmative action plan was narrowly tailored: 1) efficacy of alternatives; 2) the relation between the percentage of minorities to be employed and the percentage of minorities in the relevant workforce; 3) the intended duration of the remedy; 4) the availability of a waiver provision; and 5) the effect on the rights of innocent third parties. *Id.*

[102] *Id.* at 1076 (Stevens, J., concurring). Justice Stevens cited Swann v. Charlotte-Mecklenburg Board of Education, 402 U.S. 1 (1971), the case he felt guided the district court in fashioning a remedy to eliminate the effects of discrimination. *Paradise*, 107 S. Ct. at 1076. He stated the court had broad equitable authority and rejected the notion that the Supreme Court should use special, narrow rules to review these decrees. *Id.* at 1077.

constitutional.[103]

In dissent,[104] Justice O'Connor reasoned that the quota was not manifestly necessary to achieve compliance with the court's previous orders,[105] and that relief far exceeded the percentage of blacks in the state trooper force.[106] Finding the court's purpose could be achieved without the use of a racial classification and considering the failure of the district court to weigh alternative remedies,[107] Justice O'Connor concluded that the remedy was not narrowly tailored to serve a compelling governmental purpose, and thus would not survive strict scrutiny.[108]

Few constitutional issues in recent years have generated the amount of controversy and emotionalism as has the question of granting preferential treatment on the basis of race.[109] These competing interests have led the Supreme Court to proceed with caution in affirmative action decisions, carefully weighing the facts and circumstances before upholding proposed plans.[110] From the uncertainties and vague guidelines of previous decisions, *Paradise* has further clarified the factors which the Supreme Court considers in upholding a classification that benefits a minority.[111] Since the school desegregation cases, the Court has conferred broad equitable power on federal district courts to remedy past unlawful discrimination.[112] In *Paradise*, the findings of

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[103] *Paradise*, 107 S. Ct. at 1079. Justice Stevens contended the Department had the burden of proving the relief was unreasonable, since it had been found guilty of repeated violations of the law. *Id.* at 1078. He compared this with racial discrimination cases in which there were no proven violations of the law, and in which the governmental decision-maker must overcome a strong presumption against it. *Id.*

[104] *Id.* at 1080. Justice O'Connor was joined in the dissent by Chief Justice Rehnquist and Justice Scalia. *Id.* Justice White filed a brief dissenting statement reciting his belief that the district court had abused its equitable powers in fashioning the remedy. *Id.* at 1080 (White, J., dissenting).

[105] *Id.* at 1080 (O'Connor, J., dissenting). Justice O'Connor stated that the one and only purpose of the district court in fashioning the remedy was to compel the department's development of a valid promotion procedure. *Id.*

[106] *Id.* at 1081. Justice O'Connor contended that for strict scrutiny to have any meaning, a promotion goal should be more closely related to the percentage of eligible black candidates. *Id.*

[107] *Id.* at 1082. Justice O'Connor argued that there were other available alternatives which would serve the district court's purposes, such as the appointment of a trustee or the levying of heavy fines, which were not even considered. *Id.*

[108] *Id.*

[109] *See* NOWAK, *supra* note 11, § 16-3, at 661.

[110] *See* Stewart, *supra* note 15, at 44.

[111] *Id.* at 106.

[112] *Id.*

egregious discrimination and non-compliance with the district court's remedial actions were key factors in the Supreme Court's ruling.[113] Absent such a history, the Court would not have upheld the quota relief, clearly limiting the *Paradise* ruling as applied to other affirmative promotion plans.[114]

An additional significance of the *Paradise* decision lies in the fact that it indicates that the Court remains sharply divided on a standard of judicial review,[115] with Justice Powell frequently casting the deciding vote.[116] *Paradise* demonstrates that a court-ordered quota will be upheld if there has been a finding of discrimination by that entity, and the remedy is narrowly tailored, flexible, and does not unnecessarily burden innocent third parties.[117] Although the standard applied by the plurality appears similar to traditional strict scrutiny, it differs since, as *Wygant* indicates, the burden of proof is on the employee challenging the plan, rather than on the governmental entity in justifying the classification.[118] *Paradise* leaves open for clarification the question of whether the Court will ultimately devise a fourth tier of review. With the retirement of Justice Powell and the subsequent elevation of Justice Kennedy from the Ninth Circuit Court of Appeals, it would appear that the Supreme Court will tread more cautiously in the future in upholding plans similar to the quota relief in *Paradise*.

Karen DeMetz Luster

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[113] *See supra* notes 14-18 and accompanying text.

[114] *See supra* notes 72, 85 and accompanying text.

[115] *See* Stewart, *supra* note 15, at 106 (describes Court's caution with respect to affirmative action).

[116] *See supra* notes 71, 82, 87 and accompanying text.

[117] *Paradise*, 107 S.Ct. at 1073-74.

[118] *See supra* notes 12, 57, 84 and accompanying text.

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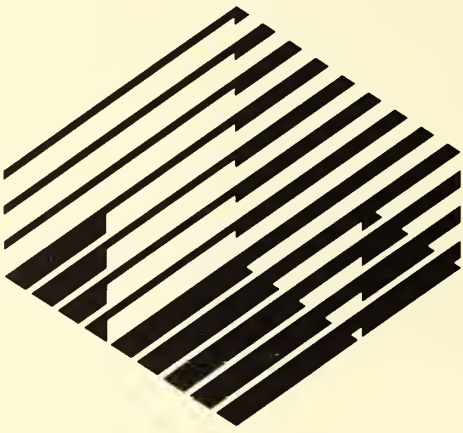

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